# DESCRIPTION OF H.R. 4520,
# THE "AMERICAN JOBS CREATION ACT OF 2004"

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 14, 2004

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

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# INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on June 14, 2004, on H.R. 4520, the "American Jobs Creation Act of 2004." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "American Jobs Creation Tax Act of 2004."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4520, the "American Jobs Creation Act of 2004"* (JCX-41-04), June 10, 2004.

## I. END SANCTIONS AND REDUCE CORPORATE TAX RATES FOR DOMESTIC MANUFACTURING AND SMALL CORPORATIONS

### A. Repeal of Exclusion for Extraterritorial Income

**Present Law**

The United States has long provided export-related benefits under a series of tax regimes, including the domestic international sales corporation ("DISC") regime, the foreign sales corporation ("FSC") regime, and the extraterritorial income ("ETI") regime. Each of these regimes has been found to violate U.S. obligations under international trade agreements. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted a new regime under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

Under the ETI regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction;[2] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[3]

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat

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[2] "Foreign trade income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

[3] "Foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes. Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

## Description of Proposal

The proposal repeals the ETI exclusion. For transactions prior to 2005, taxpayers retain 100 percent of their ETI benefits. For transactions after 2004, the proposal provides taxpayers with 80 percent of their otherwise-applicable ETI benefits for transactions during 2005 and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006. However, the proposal provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract[4] between the taxpayer and an unrelated person and such contract is in effect on January 14, 2002, and at all times thereafter.

In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits are allowed to revoke such elections within one year of the date of enactment of the proposal without recognition of gain or loss, subject to anti-abuse rules.

## Effective Date

The proposal is effective for transactions after December 31, 2004.

[4] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract.

## B. Reduced Corporate Income Tax Rate for Domestic Production Activities Income

### Present Law

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

**Table 1.–Marginal Federal Corporate Income Tax Rates for 2004**

| Taxable income: | Income tax rate: |
|---|---|
| $0 - $50,000 ......................................... | 15 percent of taxable income |
| $50,001 - $75,000 ................................ | 25 percent of taxable income |
| $75,001 - $10,000,000 ......................... | 34 percent of taxable income |
| Over $10,000,000................................. | 35 percent of taxable income |

The benefit of the first two graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

Under present law, there is no provision that reduces the corporate income tax for taxable income attributable to domestic production activities.

### Description of Proposal

**In general**

The proposal provides that the corporate tax rate applicable to qualified production activities income may not exceed 32 percent (34 percent for taxable years beginning before 2007) of the qualified production activities income.

**Qualified production activities income**

"Qualified production activities income" is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[5]

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[5] The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

**Domestic production gross receipts**

"Domestic production gross receipts" generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;[6] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction, engineering or architectural services performed in the United States for construction projects located in the United States. However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[7]

"Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(4) of the Code. "Qualified film" is any property described in section 168(f)(3) of the Code (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (other than compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

Under the bill, an election under section 631(a) made by a corporate taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

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[6] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer). Domestic production gross receipts also include gross receipts of a taxpayer derived from any sale, exchange or other disposition of food products with respect to which the taxpayer performs processing activities (in whole or in significant part) within the United States.

[7] It is intended that principles similar to those under the present-law extraterritorial income regime apply for this purpose. *See* Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person.

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2004.

## C. Reduced Corporate Income Tax Rate for Small Corporations

### Present Law

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

**Table 1.–Marginal Federal Corporate Income Tax Rates for 2004**

| Taxable income: | Income tax rate: |
|---|---|
| $0 - $50,000 ........................................ | 15 percent of taxable income |
| $50,001 - $75,000 ................................ | 25 percent of taxable income |
| $75,001 - $10,000,000 ......................... | 34 percent of taxable income |
| Over $10,000,000................................. | 35 percent of taxable income |

The benefit of the first two graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

### Description of Proposal

Under the bill, a corporation's regular income tax liability is determined by applying the following tax rate schedules to its taxable income.

**Table 2.–Marginal Federal Corporate Income Tax Rates for 2013 and thereafter**

| Taxable income: | Income tax rate: |
|---|---|
| $0 - $50,000 ........................................ | 15 percent of taxable income |
| $50,001 - $75,000 ................................ | 25 percent of taxable income |
| $75,001 - $20,000,000 ......................... | 32 percent of taxable income |
| Over $20,000,000................................. | 35 percent of taxable income |

The benefit of the graduated rates described above is phased out by a three-percent surcharge for corporations with taxable income between $20 million and $40,341,667; a corporation with taxable income of $40,341,667 or more effectively is subject to a flat rate of 35 percent.

**Table 3.–Marginal Federal Corporate Income Tax Rates for 2011-2012**

| Taxable income: | Income tax rate: |
| --- | --- |
| $0 - $50,000 | 15 percent of taxable income |
| $50,001 - $75,000 | 25 percent of taxable income |
| $75,001 - $5,000,000 | 32 percent of taxable income |
| $5,000,001 - $10,000,000 | 34 percent of taxable income |
| Over $10,000,000 | 35 percent of taxable income |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $5,000,000 and $7,205,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

**Table 4.–Marginal Federal Corporate Income Tax Rates for 2008-2010**

| Taxable income: | Income tax rate: |
| --- | --- |
| $0 - $50,000 | 15 percent of taxable income |
| $50,001 - $75,000 | 25 percent of taxable income |
| $75,001 - $1,000,000 | 32 percent of taxable income |
| $1,000,001 - $10,000,000 | 34 percent of taxable income |
| Over $10,000,000 | 35 percent of taxable income |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,605,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

**Table 5.–Marginal Federal Corporate Income Tax Rates for 2005-2007**

| Taxable income: | Income tax rate: |
| --- | --- |
| $0 - $50,000 | 15 percent of taxable income |
| $50,001 - $75,000 | 25 percent of taxable income |
| $75,001 - $1,000,000 | 33 percent of taxable income |
| $1,000,001 - $10,000,000 | 34 percent of taxable income |
| Over $10,000,000 | 35 percent of taxable income |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,420,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2004.

# II. JOB CREATION INCENTIVES FOR MANUFACTURES, SMALL BUSINESSES, AND FARMERS

## A. Extension of Increased Section 179 Expensing for Small Businesses

### Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[8] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[9] In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment could elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Under present law, an expensing election is made under rules prescribed by the Secretary.[10] Applicable Treasury Regulations provide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates.[11]

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[8] Pub. Law No. 108-27, sec. 202 (2003).

[9] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), or a renewal community (sec. 1400J).

[10] Sec. 179(c)(1).

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an expensing election may be revoked only with consent of the Commissioner.[12] JGTRRA permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.[13]

## Description of Proposal

The proposal extends the increased amount that a taxpayer may deduct, and other changes that were made by JGTRRA of 2003, for an additional two years. Thus, the proposal provides that the maximum dollar amount that may be deducted under section 179 is $100,000 for property placed in service in taxable years beginning before 2008 ($25,000 for taxable years beginning in 2008 and thereafter). In addition, the $400,000 amount applies for property placed in service in taxable years beginning before 2008 ($200,000 for taxable years beginning in 2008 and thereafter). The proposal extends, through 2007 (from 2005), the indexing for inflation of both the maximum dollar amount that may be deducted and the $400,000 amount. The proposal also includes off-the-shelf computer software placed in service in taxable years beginning before 2008 as qualifying property. The proposal permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning before 2008. The Committee expects that the Secretary will prescribe regulations to permit a taxpayer to make an expensing election on an amended return without the consent of the Commissioner.

## Effective Date

The proposal is effective on the date of enactment.

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[11] Treas. Reg. sec. 1.179-5. Under these regulations, a taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions).

[12] Sec. 179(c)(2).

[13] *Id*.

## B. Depreciation

### 1. Recovery period for depreciation of certain leasehold improvements and restaurant property

#### Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

**Depreciation of leasehold improvements**

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[14] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[15] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c), (d)(2), and (i)(6)).[16]

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

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

[16] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH)

**Qualified leasehold improvement property**

The Job Creation and Worker Assistance Act of 2002, as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

**Treatment of dispositions of leasehold improvements**

A lessor of leased property that disposes of a leasehold improvement that was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease. This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

## Description of Proposal

The proposal provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006.[17] The proposal requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction (sec. 168(k)), with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

The proposal also provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.[18] For purposes of the proposal, qualified

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1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

[17] Qualified leasehold improvement property continues to be eligible for the additional first-year depreciation deduction under sec. 168(k).

restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The proposal requires that qualified restaurant property be recovered using the straight-line method.

**Effective Date**

The proposal is effective for property placed in service after the date of enactment.

**2. Modification of depreciation allowance for aircraft**

**Present Law**

**In general**

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

**Thirty-percent additional first year depreciation deduction**

The Job Creation and Worker Assistance Act of 2002[19] ("JCWAA") allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[20] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[21] The basis of the property and the depreciation allowances in the year of purchase and

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[18] Qualified restaurant property would become eligible for the additional first-year depreciation deduction under sec. 168(k) by virtue of the assigned 15-year recovery period.

[19] Pub. Law No. 107-147, sec. 101 (2002), as amended by Pub. Law No. 108-27, sec. 201 (2003).

[20] The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

[21] However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are generally no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.[22]

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property (1) to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[23] Second, the original use[24] of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must acquire the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005.

An extension of the placed-in-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[25] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005.[26] For property eligible for the extended

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[22] A taxpayer may elect out of the 50-percent additional first-year depreciation (discussed below) for any class of property and still be eligible for the 30-percent additional first-year depreciation.

[23] A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

[24] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If, in the normal course of its business, a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[25] In order for property to qualify for the extended placed-in-service date, the property must be subject to section 263A by reason of having a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

[26] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

placed-in-service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2005 ("progress expenditures") is eligible for the additional first-year depreciation.[27]

**Fifty-percent additional first year depreciation**

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA")[28] provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. Property eligible for the 50-percent additional first-year depreciation deduction is not eligible for the 30-percent additional first-year depreciation deduction.

In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005, and no binding written contract for the acquisition can be in effect before May 6, 2003.[29] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed-in-service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2005 are eligible for the additional first-year depreciation.[30]

**Description of Proposal**

The proposal provides criteria under which certain non-commercial aircraft can qualify for the extended placed in service date. Qualifying aircraft would be eligible for the additional first-year depreciation deduction if placed in service before January 1, 2006. In order to qualify, the aircraft must:

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[27] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

[28] Pub. L. No. 108-27, sec. 201 (2003).

[29] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to May 6, 2003. However, no 50 percent additional first-year depreciation is permitted on any such component. No inference is intended as to the proper treatment of components placed in service under the 30 percent additional first-year depreciation provided by the JCWAA.

[30] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

(a) meet the appropriate placed-in-service date requirements;

(b) not be tangible personal property used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes);

(c) be purchased by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of at least ten percent of the cost or $100,000; and

(d) have an estimated production period exceeding four months and a cost exceeding $200,000.

## Effective Date

The proposal is effective as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002, which applies to property placed in service after September 10, 2001. However, because the property described by the provision qualifies for the additional first-year depreciation deduction under present law if placed in service prior to January 1, 2005, the provision will only modify the treatment of property placed in service during calendar year 2005.

### 3. Modification of placed in service rule for bonus depreciation property

## Present Law

Section 101 of the Job Creation and Worker Assistance Act of 2002 ("JCWAA") provides generally for 30-percent additional first-year depreciation, and provides a binding contract rule in determining property that qualifies for it. The requirements that must be satisfied in order for property to qualify include that (1) the original use of the property must commence with the taxpayer on or after September 11, 2001, (2) the taxpayer must acquire the property after September 10, 2001 and before September 11, 2004, and (3) no binding written contract for the acquisition of the property is in effect before September 11, 2001 (or, in the case of self-constructed property, manufacture, construction, or production of the property does not begin before September 11, 2001). In addition, the Act provides a special rule in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. The Act did not specifically address the syndication of a lease by the lessor.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. Property with respect to which the 50-percent additional first-year depreciation deduction is claimed is not also eligible for the 30-percent additional first-year depreciation deduction. In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005, and no binding written contract for the acquisition can be in effect before May 6, 2003. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003.

### Description of Proposal

The proposal provides that if property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. The provision also provides a special rule in the case of multiple units of property subject to the same lease. In such cases, property will qualify as placed in service on the date of sale if it is sold within three months after the final unit is placed in service, so long as the period between the time the first and last units are placed in service does not exceed 12 months.

### Effective Date

The proposal is generally effective as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002. However, the special rule in the case of multiple units of property subject to the same lease applies to property sold after June 4, 2004.

## C. Proposals Relating to S Corporation Reform and Simplification

### Overview

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

### 1. Shareholders of an S corporation

### Present Law

**In general**

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[31] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, a Domestic International Sales Corporation ("DISC") or former DISC.

**Individual retirement accounts**

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified

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[31] If a charity or a qualified retirement plan holds stock in an S corporation, the interest held is treated as an interest in an unrelated trade or business, and the charity's or plan's share of the S corporation's items of income, loss, or deduction, and gain or loss on the disposition of the S corporation stock, are taken into account in computing unrelated business taxable income.

distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Under present law, an IRA cannot be a shareholder of an S corporation.

Certain transactions are prohibited between an IRA and the individual for whose benefit the IRA is established, including a sale of property by the IRA to the individual. If a prohibited transaction occurs between an IRA and the IRA beneficiary, the account ceases to be an IRA, and an amount equal to the fair market value of the assets held in the IRA is deemed distributed to the beneficiary.

## Description of Proposal

### In general

The bill provides that all family members can elect to be treated as one shareholder for purposes of determining the number of shareholders in the corporation. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than three generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this proposal, if later). Except as provided by Treasury regulations, the election for a family may be made by any family member and remains in effect until terminated.

The bill increases the maximum number of eligible shareholders from 75 to 100.

### Individual retirement accounts

The bill allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment of the proposal.[32]

The bill also provides an exemption from prohibited transaction treatment for the sale by an IRA to the IRA beneficiary of bank stock held by the IRA on the date of enactment of the proposal. Under the bill, a sale is not a prohibited transaction if: (1) the sale is pursuant to an S corporation election by the bank; (2) the sale is for fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party; (3) the IRA incurs no commissions, costs, or other expenses in connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

[32] Under the bill, the present-law rules treating S corporation stock held by a qualified retirement plan or a charity as an interest in an unrelated trade or business apply also to an IRA holding stock of a bank that is an S corporation.

## Effective Date

The proposals generally apply to taxable years beginning after December 31, 2004. The provision relating to IRAs takes effect on the date of enactment.

### 2. Treatment of S corporation shareholders

#### (a) Electing small business trusts

## Present Law

An electing small business trust ("ESBT") holding stock in an S corporation is taxed at the maximum individual tax rate on its ratable share of items of income, deduction, gain, or loss passing through from the S corporation. An ESBT generally is an electing trust all of whose beneficiaries are eligible S corporation shareholders. For purposes of determining the maximum number of shareholders, each person who is entitled to receive a distribution from the trust ("potential current beneficiary") is treated as a shareholder during the period the person may receive a distribution from the trust.

An ESBT has 60 days to dispose of the S corporation stock after an ineligible shareholder becomes a potential current beneficiary to avoid disqualification.

## Description of Proposal

Under the bill, powers of appointment to the extent not exercised are disregarded in determining the potential current beneficiaries of an electing small business trust.

The bill increases the period during which an ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from 60 days to one year.

## Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

#### (b) Qualified subchapter S trusts

## Present Law

Under present law, the share of income of an S corporation whose stock is held by a qualified subchapter S trust ("QSST"), with respect to which the beneficiary makes an election, is taxed to the beneficiary. However, the trust, and not the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of the disposition of the S corporation stock by the trust. A QSST generally is a trust with one individual income beneficiary for the life of the beneficiary.

### Description of Proposal

Under the bill, the beneficiary of a qualified subchapter S trust is generally allowed to deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S corporation stock.

### Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

**(c) Transfers of losses incident to divorce, etc.**

### Present Law

Under present law, any loss or deduction that is not allowed to a shareholder of an S corporation, because the loss exceeds the shareholder's basis in stock and debt of the corporation, is treated as incurred by the S corporation with respect to that shareholder in the subsequent taxable year.

### Description of Proposal

Under the bill, if a shareholder's stock in an S corporation is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent taxable year.

### Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

**3. Proposals relating to banks**

**(a) Exclusion of investment securities income from passive income test for bank S corporations**

### Present Law

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.

#### Description of Proposal

The bill provides that, in the case of a bank or bank holding company, interest income and dividends on assets required to be held by the bank or bank holding company are not treated as passive investment income for purposes of applying the excess net passive income rules.

#### Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

### (b) Treatment of qualifying director shares

#### Present Law

An S corporation may have only one outstanding class of stock.

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.

#### Description of Proposal

Under the bill, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S. Thus, the stock will not be treated as a second class of stock; the holder of the stock will not be treated as a shareholder by reason of the ownership of the stock; and the stock will be disregarded in allocating items of income, loss, etc. among the shareholders.

Restricted bank director stock means shares in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act) held by an individual solely by reason of status as a director of the bank or company and which are subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder agrees to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

Distributions (not in exchange for the stock) with respect to the restricted shares are includible in the gross income of the director and deductible by the S corporation.

## Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

### 4. Qualified subchapter S subsidiaries

#### (a) Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations

## Present Law

Under present law, inadvertent invalid subchapter S elections and terminations may be waived.

## Description of Proposal

The bill allows inadvertent invalid qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

## Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

#### (b) Information returns for qualified subchapter S subsidiaries

## Present Law

Under present law, a corporation all of whose stock is held by an S corporation is treated as a qualified subchapter S subsidiary if the S corporation so elects. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

## Description of Proposal

The bill provides authority to the Secretary of the Treasury to provide guidance regarding information returns of qualified subchapter S subsidiaries.

## Effective Date

The proposal applies to taxable years beginning after December 31, 2004.

### 5. Repayment of loan for qualifying employer securities held by an ESOP

## Present Law

An employee stock ownership plan (an "ESOP") is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[33] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property between a plan and a disqualified person, (2) the lending of money or other extension of credit between a plan and a disqualified person, and (3) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.[34] In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer securities held by the ESOP are used to repay the loan. The employer securities are held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[35] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[36] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief

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[33] Sec. 4975.

[34] Sec. 4975(d)(3). An ESOP that borrows money to purchase employer stock is referred to as a "leveraged" ESOP.

[35] Treas. Reg. sec. 54.4975-7(b)(5).

[36] Sec. 404(k)(5)(B).

does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.[37]

## Description of Proposal

Under the bill, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to repay a loan that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

## Effective Date

The proposal is effective for distributions made with respect to S corporation stock after December 31, 2004.

[37] Sec. 404(k)(2)(B).

## D. Alternative Minimum Tax Relief

### 1. Foreign tax credit under the alternative minimum tax; expansion of exemption from alternative minimum tax for small corporations; coordinate farmers' income averaging and the alternative minimum tax

#### Present Law

**In general**

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of such items.

**Foreign tax credit**

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI. Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to total AMTI.

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit. For example, assume that a corporation has $10 million of AMTI, has no AMT net operating loss deduction, and has no regular tax liability. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back two years and carried forward five years for use against AMT in those years under the principles of the foreign tax credit carryback and carryover rules set forth in section 904(c).

**Small corporation exemption**

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

**Farmer income averaging**

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

## Description of Proposal

The bill repeals the 90-percent limitation on the utilization of the AMT foreign tax credit.

The bill increases the amount of average gross receipts that an exempt corporation may receive from $7.5 million to $20 million.

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

## Effective Date

The proposal relating to the foreign tax credit applies to taxable years beginning after December 31, 2004.

The proposal relating to the small corporation exemption applies to taxable years beginning after December 31, 2005.

The proposal relating to farmers' income averaging applies to taxable years beginning after December 31, 2003.

## E. Restructuring of Incentives for Alcohol Fuels

### 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.[38]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[39]) 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. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. 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. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.[40]

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

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[38] 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.

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

[40] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 38.52 cents for sales or uses during calendar year 2004, and 37.78 cents for calendar years 2005, 2006, and 2007.

**Excise tax reductions for alcohol mixture fuels**

Generally, motor fuels tax rates are as follows:[41]

| | |
|---|---|
| Gasoline | 18.3 cents per gallon |
| Diesel fuel and kerosene | 24.3 cents per gallon |
| Special motor fuels | 18.3 cents per gallon generally |

Alcohol-blended fuels are subject to a reduced rate of tax. The benefits provided by the alcohol fuels income tax credit and the excise tax reduction are integrated such that the alcohol fuels credit is reduced to take into account the benefit of any excise tax reduction.

Gasohol

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.

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2004, the following reduced rates apply to gasohol:[42]

| | |
|---|---|
| 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 |

Reduced excise tax rates also apply when gasoline is being purchased for the production of "gasohol." When gasoline is purchased for blending into gasohol, the rates above are multiplied by a fraction (*e.g.,* 10/9 for 10-percent gasohol) so that the increased volume of motor fuel will be subject to tax. The reduced tax rates apply if the person liable for the tax is registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or

[41] These fuels are also subject to an additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund. See secs. 4041(d) and 4081(a)(2)(B). In addition, the basic fuel tax rate will drop to 4.3 cents per gallon beginning on October 1, 2005.

[42] These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund. These special rates will terminate after September 30, 2007 (sec. 4081(c)(8)).

entering the gasoline or (2) gasoline is sold upon its removal or entry and such person has an unexpired certificate from the buyer and has no reason to believe the certificate is false.[43]

Qualified methanol and ethanol fuels

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.[44] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2004 is 13.15 cents. From January 1, 2005 through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.

Alcohol produced from natural gas

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.[45] For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other cases, the rate is 11.4 cents per gallon. After September 30, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

A reduced rate of tax applies to diesel fuel or kerosene that is combined with alcohol as long as at least 10 percent of the finished mixture is alcohol. If none of the alcohol in the mixture is ethanol, the rate of tax is 18.4 cents per gallon. For alcohol mixtures containing ethanol, the rate of tax in 2004 is 19.2 cents per gallon and 19.3 cents per gallon for 2005 through September 30, 2007. Fuel removed or entered for use in producing a 10 percent diesel-alcohol fuel mixture (without ethanol), is subject to a tax of 20.44 cents per gallon. The rate of tax for fuel removed or entered for use to produce a 10 percent diesel-ethanol fuel mixture is 21.333 cents per gallon for 2004 and 21.444 cents per gallon for the period January 1, 2005 through September 30, 2007.[46]

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[43] 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.

[44] These reduced rates terminate after September 30, 2007. Included in these rates is the 0.05-cent-per-gallon Leaking Underground Storage Tank Trust Fund tax imposed on such fuel. (sec. 4041(b)(2)).

[45] These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund (sec. 4041(d)(1)).

[46] These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund.

Special motor fuel (nongasoline) mixtures with alcohol also are taxed at reduced rates.

Aviation fuel

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.[47] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[48] In the case of 10 percent ethanol mixtures, for any sale or use during 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007.[49]

When aviation fuel is purchased for blending with alcohol, the rates above are multiplied by a fraction (10/9) so that the increased volume of aviation fuel will be subject to tax.

**Refunds and payments**

If fully taxed gasoline (or other taxable fuel) is used to produce a qualified alcohol mixture, the Code permits the blender to file a claim for a quick excise tax refund. The refund is equal to the difference between the gasoline (or other taxable fuel) excise tax that was paid and the tax that would have been paid by a registered blender on the alcohol fuel 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. A claim may be filed by any person with respect to gasoline, diesel fuel, or kerosene used to produce a qualified alcohol fuel mixture for any period for which $200 or more is payable and which is not less than one week.

**Ethyl tertiary butyl ether (ETBE)**

Ethyl tertiary butyl ether ("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 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.

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[47] This rate includes the additional 0.1 cent-per-gallon tax for the Leaking Underground Storage Tank Trust fund.

[48] Secs. 4041(k)(1) and 4091(c).

[49] Sec. 4091(c)(1).

## Highway Trust Fund

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per gallon of the tax imposed is retained in the General Fund.[50] In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.[51]

## Taxes from gasoline and special motor fuels used in motorboats and gasoline used in the nonbusiness use of small-engine outdoor power equipment

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels, as well as small-engine fuel taxes, that are first deposited into the Highway Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions.[52]

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, the Code currently transfers 13.5 cents per gallon from the Highway Trust Fund to the Aquatics Resources Trust Fund and Land and Water Conservation Fund. The remainder, 4.8 cents per gallon, is retained in the General Fund. In addition, the Sport Fish Restoration Account of the Aquatics Resources Trust Fund receives 13.5 cents per gallon of the revenues from the tax imposed on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. The balance of 4.8 cents per gallon is retained in the General Fund.[53]

## Description of Proposal

## Overview

The proposal eliminates reduced rates of excise tax for alcohol-blended fuels and imposes the full rate of excise tax on alcohol-blended fuels (18.4 cents per gallon on gasoline blends and 24.4 cents per gallon of diesel blended fuel). In place of reduced rates, the proposal permits the section 40 alcohol mixture credit, with certain modifications, to be applied against excise tax liability. The credit may be taken against the tax imposed on taxable fuels (by section 4081). To the extent a person does not have section 4081 liability, the proposal allows taxpayers to file a claim for payment equal to the amount of the credit for the alcohol used to produce an eligible

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

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

[52] Sec. 9503(c)(4) and 9503(c)(5).

[53] The Sport Fish Restoration Account also is funded with receipts from an *ad valorem* manufacturer's excise tax on sport fishing equipment.

mixture. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit is claimed with respect to alcohol used in the production of any alcohol mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The proposal eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund.

## Alcohol fuel mixture excise tax credit and payment provisions

### Alcohol fuel mixture excise tax credit

The proposal eliminates the reduced rates of excise tax for alcohol-blended fuels and taxable fuels used to produce an alcohol fuel mixture. Under the proposal, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture.

In lieu of the reduced excise tax rates, the proposal provides that the alcohol mixture credit provided under section 40 may be applied against section 4081 excise tax liability (hereinafter referred to as "the alcohol fuel mixture credit"). The credit is treated as a payment of the taxpayer's tax liability received at the time of the taxable event. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. The credit declines to 51 cents per gallon after calendar year 2004. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon. As discussed further below, the excise tax credit is refundable in order to provide a benefit equivalent to the reduced tax rates, which are being repealed under the proposal.

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and gasoline or alcohol and a special fuel which is sold for use or used as a fuel by the taxpayer producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Special fuel is any liquid fuel (other than gasoline) which is suitable for use in an internal combustion engine. The benefit obtained from the excise tax credit is coordinated with the alcohol fuels income tax credit. For refiners making an alcohol fuel mixture with ETBE, the mixture is treated as sold to another person for use as a fuel only upon removal from the refinery. The excise tax credit is available through December 31, 2010.

### Payments with respect to qualified alcohol fuel mixtures

To the extent the alcohol fuel mixture credit exceeds any section 4081 liability of a person, the Secretary is to pay such person an amount equal to the alcohol fuel mixture credit with respect to such mixture. These payments are intended to provide an equivalent benefit to replace the partial exemption for fuels to be blended with alcohol and alcohol fuels being repealed by the proposal. If claims for payment 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. If claims are filed electronically, the claimant may make a claim for less than $200.

The proposal does not apply with respect to alcohol fuel mixtures sold after December 31, 2010.

**Alcohol fuel subsidies borne by General Fund**

The proposal eliminates the requirement that 2.5 and 2.8 cents per gallon of excise taxes be retained in the General Fund with the result that the full amount of tax on alcohol fuels is credited to the Highway Trust Fund. The proposal also authorizes the full amount of fuel taxes to be appropriated to the Highway Trust Fund without reduction for amounts equivalent to the excise tax credits allowed for alcohol fuel mixtures, and the Trust Fund is not required to reimburse any payments with respect to qualified alcohol fuel mixtures.

**Motorboat and small engine fuel taxes**

The proposal eliminates the General Fund retention of the 4.8 cents per gallon of the taxes imposed on gasoline and special motor fuels used in motorboats and gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment.

## Effective Dates

The proposals generally are effective for fuel sold or used after September 30, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon of tax regarding alcohol fuels and the repeal of the 4.8 cents per gallon General Fund retention of the taxes imposed on fuels used in motorboats and small engine equipment is effective for taxes imposed after September 30, 2003. The proposal regarding the crediting of the full amount of tax to the Highway Trust Fund without regard to credits and payments is effective for taxes received after September 30, 2004, and payments made after September 30, 2004.

## F. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options from Wages

### Present Law

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[54]

If the statutory holding period requirements are satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option.

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[55] The applicable Code provisions[56] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option.

There has been uncertainty in the past as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[57]

### Description of Proposal

The proposal provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the proposal,

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[54] Sec. 421. For purposes of the individual alternative minimum tax, the transfer of stock pursuant to an incentive stock option is generally treated as the transfer of stock pursuant to a nonstatutory option. Sec. 56(b)(3).

[55] Secs. 3101, 3111 and 3301.

[56] Secs. 3121 and 3306.

[57] Notice 2002-47, 2002-28 I.R.B. 97.

FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[58] The proposal also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the proposal provides that Federal income tax withholding is not required on a disqualifying disposition, nor when compensation is recognized in connection with an employee stock purchase plan discount. Present law reporting requirements continue to apply.

**Effective Date**

The proposal is effective for stock acquired pursuant to options exercised after the date of enactment.

[58] The provision also provides a similar exclusion under the Railroad Retirement Tax Act.

## G. Incentives to Reinvest Foreign Earnings in the United States

### Present Law

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. 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 generally is deferred. However, under anti-deferral rules, the domestic parent corporation may 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 provisions in this context are the controlled foreign corporation rules of subpart F[59] and the passive foreign investment company rules.[60] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included in income under the anti-deferral rules.[61]

### Description of Proposal

Under the proposal, certain dividends received by a U.S. corporation from a controlled foreign corporation are eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either: (1) during the first six months of the taxpayer's first taxable year beginning on or after the date of enactment of the bill; or (2) during any six-month or shorter period after the date of enactment of the bill, during the taxpayer's last taxable year beginning before such date. Dividends received after the election period will be taxed in the normal manner under present law.

The deduction applies only to dividends and other amounts included in gross income as dividends (e.g., amounts described in section 1248(a)). The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956. Similarly, the deduction does not apply to distributions of earnings previously taxed under subpart F, except to the extent that the subpart F inclusions result from the payment of a dividend by one controlled foreign corporation to another controlled foreign corporation within a certain chain of ownership during the election period. This exception enables multinational corporate groups to qualify for the deduction in connection with the repatriation of earnings from lower-tier controlled foreign corporations.

The deduction is subject to a number of limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before March 31, 2003, determined by disregarding the highest-repatriation

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[59] Secs. 951-964.

[60] Secs. 1291-1298.

[61] Secs. 901, 902, 960, 1291(g).

year and the lowest-repatriation year among such five years (the "base-period average"). In addition to actual dividends, deemed repatriations under section 956 and distributions of earnings previously taxed under subpart F are included in the base-period average.

Second, the amount of dividends eligible for the deduction is limited to the greatest of: (1) $500 million; (2) the amount of earnings shown as permanently invested outside the United States on the taxpayer's most recent audited financial statement which is certified on or before March 31, 2003; or (3) in the case of an applicable financial statement that fails to show a specific amount of such earnings, but that does show a specific amount of tax liability attributable to such earnings, the amount of such earnings determined in such manner as the Treasury Secretary may prescribe.

Third, dividends qualifying for the deduction must be invested in the United States pursuant to a plan approved by the senior management and board of directors of the corporation claiming the deduction.

The bill provides that no foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend received during the taxable year for which an election under the proposal is in effect. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which are not; in the absence of such identification, a pro rata amount of foreign tax credits will be disallowed with respect to every dividend received during the taxable year.

The bill also provides that the income attributable to the nondeductible portion of a qualifying dividend may not be offset by net operating losses, and the tax attributable to such income generally may not be offset by credits (other than foreign tax credits and AMT credits) and may not reduce the alternative minimum tax otherwise owed by the taxpayer. No deduction under sections 243 or 245 is allowed for any dividend for which a deduction is allowed under the proposal.

## Effective Date

The proposal is effective for a taxpayer's first taxable year beginning on or after the date of enactment of the bill, or the taxpayer's last taxable year beginning before such date, at the taxpayer's election.

## H. Other Incentive Provisions

### 1. Special rules for livestock sold on account of weather-related conditions

**Present Law**

Generally, a taxpayer realizes gain to the extent the sales price (and any other consideration received) exceeds the taxpayer's basis in the property. The realized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period"). Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially-declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

Section 1033(e) provides that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions is treated as an involuntary conversion. Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

**Description of Proposal**

The proposal extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. The extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than three years. Also, for property eligible for the proposal's extended replacement period, the proposal provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

**Effective Date**

The proposal is effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

### 2. Payment of dividends on stock of cooperatives without reducing patronage dividends

**Present Law**

Under present law, cooperatives generally are treated similarly to pass-through entities in that a cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid enforceable written obligation to the patron that was in existence before the cooperative received such amounts, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[62] The effect of this rule is to reduce the amount of earnings that a cooperative can treat as patronage income and, thus, the amount that the cooperative can deduct as patronage dividends.

**Description of Proposal**

The proposal provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income.

**Effective Date**

The proposal is effective for distributions made in taxable years beginning after the date of enactment.

[62] Treas. Reg. sec. 1.1388-1(a)(1).

### 3. Capital gains treatment to apply to outright sales of timber by landowner

**Present Law**

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber that is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

**Descripion of Proposal**

Under the bill, in the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain under section 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify under present law, except that the usual tax rules relating to the timing of the income from the sale of the timber will apply (rather than the special rule of section 631(b) treating the disposal as occurring on the date the timber is cut).

**Effective Date**

The proposal is effective for sales of timber after December 31, 2004.

### 4. Distributions from publicly traded partnerships treated as qualifying income of regulated investment company

**Present Law**

**Treatment of RICs**

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. In computing its taxable income, a RIC deducts dividends paid to its shareholders to achieve conduit treatment (sec. 852(b)). In order to qualify for conduit treatment, a RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, the corporation must elect RIC status, and must satisfy certain other requirements (sec. 851(b)).

One of the RIC qualification requirements is that at least 90 percent of the RIC's gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies (sec. 851(b)(2)).

Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the "look-through" rule for partnership income) (sec. 851(b)). Under present law, no distinction is made under this rule between a publicly traded partnership and any other partnership.

The RIC qualification rules include limitations on the ownership of assets and on the composition of the RIC's assets (sec. 851(b)(3)). Under the ownership limitation, at least 50 percent of the value of the RIC's total assets must be represented by cash, government securities and securities of other RICs, and other securities; however, in the case of such other securities, the RIC may invest no more than five percent of the value of the total assets of the RIC in the securities of any one issuer, and may hold no more than 10 percent of the outstanding voting securities of any one issuer. Under the limitation on the composition of the RIC's assets, no more than 25 percent of the value of the RIC's total assets may be invested in the securities of any one issuer (other than Government securities), or in securities of two or more controlled issuers in the same or similar trades or businesses. These limitations generally are applied at the end of each quarter (sec. 851(d)).

**Treatment of publicly traded partnerships**

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation (sec. 7704(a)), but an exception to corporate treatment is provided if 90 percent or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income (sec. 7704(c) and (d)).

A special rule for publicly traded partnerships applies under the passive loss rules. The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. The special rule for publicly traded partnerships provides that the passive loss rules are applied separately with respect to items attributable to each publicly traded partnership (sec. 469(k)). Thus, income or loss from the publicly traded partnership is treated as separate from income or loss from other passive activities.

## Description of Proposal

The proposal modifies the 90 percent test with respect to income of a RIC to include income derived from an interest in a publicly traded partnership. The proposal also modifies the lookthrough rule for partnership income of a RIC so that it applies only to income from a partnership other than a publicly traded partnership.

The proposal provides that the limitation on ownership and the limitation on composition of assets that apply to other investments of a RIC also apply to RIC investments in publicly traded partnership interests.

The proposal provides that the special rule for publicly traded partnerships under the passive loss rules (requiring separate treatment) applies to a RIC holding an interest in a publicly traded partnership, with respect to items attributable to the interest in the publicly traded partnership.

**Effective Date**

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

### 5. Improvements related to real estate investment trusts

**Present Law**

**In general**

Real estate investment trusts ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. Whether the REIT meets the asset tests is generally measured each quarter.

**Organizational structure requirements**

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

**Income requirements**

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property.

Qualified rental income

Amounts received as impermissible "tenant services income" are not treated as rents from real property.[63] In general, such amounts are for services rendered to tenants that are not "customarily furnished" in connection with the rental of real property.[64] Special rules also permit amounts to be received from certain "foreclosure property" treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[65] An exception applies to rents received from a taxable REIT subsidiary ("TRS") (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[66]

Certain hedging instruments

Except as provided in regulations, a payment to a REIT under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, and any gain from the sale or disposition of any such investment, is treated as income qualifying for the 95-percent income test.

Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-percent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured

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[63] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

[64] Rents for certain personal property leased in connection with the rental of real property are treated as rents from real property if the fair market value of the personal property does not exceed 15 percent of the aggregate fair market values of the real and personal property

[65] Sec. 856(d)(2)(B).

[66] Sec. 856(d)(8).

by the greater of the amount by which 90 percent [67] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[68]

## Asset requirements

### 75-percent asset test

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (the "75-percent asset test"). The term real estate asset is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

### Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.

### "Straight debt" exception

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S)[69] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if : 1) the issuer is an individual, 2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or 3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt for purposes of the REIT provision [70] is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the

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[67] Prior to 1999, the rule had applied to the amount by which 95 percent of the income exceeded the items subject to the 95 percent test.

[68] The ratio of the REIT's net to gross income is applied to the excess amount, to determine the amount of tax (disregarding certain items otherwise subject to a 100-percent tax). In effect, the formula seeks to require that all of the REIT net income attributable to the failure of the income tests will be paid as tax. Sec. 857(b)(5).

[69] Sec. 1361(c)(5), without regard to paragraph (B)(iii) thereof.

[70] Sec. 856(c)(7).

interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and (ii) there is no convertibility (directly or indirectly) into stock.

Certain subsidiary ownership permitted with income treated as income of the REIT

Under one exception to the rule limiting a REIT's securities holdings to no more than 10 percent of the vote or value of a single issuer, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT.

Special rules for Taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a real estate investment trust[71] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass-through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[72]

Rents subject to the 100 percent excise tax do not include rents for services of a TRS that are for services customarily furnished or rendered in connection with the rental of real property.

They also do not include rents from a TRS that are for real property or from incidental personal property provided with such real property.

**Income distribution requirements**

A REIT is generally required to distribute 90 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. If a

[71] Certain corporations are not eligible to be a TRS, such as a corporation which directly or indirectly operates or manages a lodging facility or a health care facility, or directly or indirectly provides to any other person rights to a brand name under which any lodging facility or health care facility is operated. Sec. 856(l)(3).

[72] If the excise tax applies, then the item is not reallocated back to the TRS under section 482.

REIT declares certain dividends after the end of its taxable year but before the time prescribed for filing its return for that year and distributes those amounts to shareholders within the 12 months following the close of that taxable year, such distributions are treated as made during such taxable year for this purpose. As described further below, a REIT can also make certain "deficiency dividends" after the close of the taxable year after a determination that it has not distributed the correct amount for qualification as a REIT.

**Consequences of failure to meet requirements**

A REIT loses its status as a REIT, and becomes subject to tax as a C corporation, if it fails to meet specified tests regarding the sources of its income, the nature and amount of its assets, its structure, and the amount of its income distributed to shareholders.

In the case of a failure to meet the source of income requirements, if the failure is due to reasonable cause and not to willful neglect, the REIT may continue its REIT status if it pays the disallowed income as a tax to the Treasury.[73]

There is no similar provision that allows a REIT to pay a penalty and avoid disqualification in the case of other qualification failures.

A REIT may make a deficiency dividend after a determination is made that it has not distributed the correct amount of its income, and avoid disqualification. The Code provides only for determinations involving a controversy with the IRS and does not provide for a REIT to make such a distribution on its own initiative. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

## Description of Proposal

The proposal makes a number of modifications to the REIT rules.

**Straight debt modification**

The proposal modifies the definition of "straight debt" for purposes of the limitation that a REIT may not hold more than 10 percent of the value of the outstanding securities of a single issuer, to provide more flexibility than the present law rule. In addition, except as provided in regulations, neither such straight debt nor certain other types of securities are considered "securities" for purposes of this rule.

Straight debt securities

As under present law, "straight-debt" is still defined by reference to section 1361(c)(5), without regard to subparagraph (B)(iii) thereof (limiting the nature of the creditor).

[73] Secs. 856(c)(6) and 857(b)(5).

Special rules are provided permitting certain contingencies for purposes of the REIT provision. Any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that the time of payment of such interest or principal is subject to a contingency, but only if one of several factors applies. The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity, but only if (i) any such contingency does not exceed the greater of ¼ of one percent or five percent of the annual yield to maturity, or (ii) neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

Also, the time or amount of any payment is permitted to be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary commercial practice.[74]

The proposal eliminates the present law rule requiring a REIT to own a 20 percent equity interest in a partnership in order for debt to qualify as "straight debt". The bill instead provides new "look-through" rules determining a REIT partner's share of partnership securities, generally treating debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership.

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than one percent of the issuer's outstanding securities.

<u>Other securities</u>

Except as provided in regulations, the following also are not considered "securities" for purposes of the rule that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer: (i) any loan to an individual or an estate, (ii) any section 467 rental agreement, (as defined in section 467(d)), other than with a person described in section 856(d)(2)(B), (iii) any obligation to pay rents from real property, (iv) any security issued by a State or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this category, or payments on any obligation issued by such an entity, (v) any security issued by a real estate investment trust; and (vi) any other arrangement that, as determined by the Secretary, is excepted from the definition of a security.

[74] The present-law rules that limit qualified interest income to amounts the determination of which do not depend, in whole or in part, on the income or profits of any person, continue to apply to such contingent interest. See, e.g., secs. 856(c)(2)(G), 856(c)(3)(G) and 856(f).

**Safe harbor testing date for certain rents**

The proposal provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a TRS to be treated as qualified rental income for purposes of the income tests.[75]

**Customary services exception**

The proposal prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[76] or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments would be free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

**Hedging rules**

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce interest rate risks are prospectively conformed to the rules included in section 1221.

**95-percent gross income requirement**

The proposal prospectively amends the tax liability owed by the REIT when it fails to meet the 95-percent of gross income test by applying a taxable fraction based on 95 percent, rather than 90 percent, of the REIT's gross income.

**Consequences of failure to meet requirements**

Under the proposal, a REIT may avoid disqualification in the event of certain failures of the requirements for REIT status, provided that 1) the failure was due to reasonable cause and not willful neglect, 2) the failure is corrected, and 3) except for certain failures not exceeding a specified de minims amount, a penalty amount is paid.

Certain de minimis asset failures of 5-percent or 10-percent tests

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a

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[75] The proposal does not modify any of the standards of section 482 as they apply to REITs and to TRSs.

[76] Although a REIT could itself provide such service and receive the income without receiving any disqualified income, in that case the REIT itself would be bearing the cost of providing the service. Under the present law exception for a TRS providing such service, there is no explicit requirement that the TRS be reimbursed for the full cost of the service.

REIT may not hold securities possessing more than 10 percent of the total voting power or 10 percent of the total value of the outstanding securities of any one issuer.[77] The requirements must be satisfied each quarter.

The proposal provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) one percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[78]

<u>Larger asset test failures (whether of 5-percent or 10-percent tests, or of 75-percent or other asset tests)</u>

Under the proposal, if a REIT fails to meet any of the asset test requirements for a particular quarter and the failure exceeds the de minimis threshold described above, then the REIT still will be deemed to have satisfied the requirements if: (i) following the REIT's identification of the failure, the REIT files a schedule with a description of each asset that caused the failure, in accordance with regulations prescribed by the Treasury; (ii) the failure was due to reasonable cause and not to willful neglect, (iii) the REIT disposes of the assets within 6 months after the last day of the quarter in which the identification occurred or such other time period as is prescribed by the Treasury (or the requirements of the rules are otherwise met within such period), and (iv) the REIT pays a tax on the failure.

The tax that the REIT must pay on the failure is the greater of (i) $50,000, or (ii) an amount determined (pursuant to regulations) by multiplying the highest rate of tax for corporations under section 11, times the net income generated by the assets for the period beginning on the first date of the failure and ending on the date the REIT has disposed of the assets (or otherwise satisfies the requirements).

Such taxes are treated as excise taxes, for which the deficiency provisions of the excise tax subtitle of the Code (subtitle F) apply.

<u>Conforming reasonable cause and reporting standard for failures of income tests</u>

The proposal conforms the reporting and reasonable cause standards for failure to meet the income tests to the new asset test standards. However, the proposal does not change the rule

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[77] Sec. 856(c)(4)(B)(iii). These rules do not apply to securities of a TRS, or to securities that qualify for the 75 percent asset test of section 856(c)(4)(A), such as real estate assets, cash items (including receivables), or Government securities.

[78] A REIT might satisfy the requirements without a disposition, for example, by increasing its other assets in the case of the 5 percent rule; or by the issuer modifying the amount or value of its total securities outstanding in the case of the 10 percent rule.

under section 857(b)(5) that for income test failures, all of the net income attributed to the disqualified gross income is paid as tax.

Other failures

The proposal adds a provision under which, if a REIT fails to satisfy one or more requirements for REIT qualification, other than the 95-percent and 75-percent gross income tests and other than the new rules provided for failures of the asset tests, the REIT may retain its REIT qualification if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of $50,000 for each such failure.

Taxes and penalties paid deducted from amount required to be distributed

Any taxes or penalties paid under the provision are deducted from the net income of the REIT in determining the amount the REIT must distribute under the 90-percent distribution requirement.

Expansion of deficiency dividend procedure

The proposal expands the circumstances in which a REIT may declare a deficiency dividend, by allowing such a declaration to occur after the REIT unilaterally has identified a failure to pay the relevant amount. Thus, the declaration need not await a decision of the Tax Court, a closing agreement, or an agreement signed by the Secretary of the Treasury.

## Effective Date

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

However, some of the proposals are effective for taxable years beginning after the date of enactment. These are: the new "look through" rules determining a REIT partner's share of partnership securities for purposes of the "straight debt" rules; the proposal changing the 90-percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-percent of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services, and the new rules for correction of certain failures to satisfy the REIT requirements.

### 6. Treatment of certain dividends of regulated investment companies

## Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and local bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

In general

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties or similar types of income, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax (sec. 871(g)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). “Portfolio interest” generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is “foreign targeted”), and (ii) that is not received by a 10-percent shareholder (secs. 871(h)(3) and 881(c)(3)). With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required (secs. 871(h)(2), (5) and 881(c)(2)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (secs. 871(h)(4) and 881(c)(4)).

Capital gains

Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, if the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year (sec. 871(a)(2)). A RIC may elect not to withhold on a distribution to a foreign person representing a capital gain dividend. (Treas. Reg. sec. 1.1441-3(c)(2)(D)).

Gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business (sec. 897). In addition to an interest in real property located in the United States or the Virgin Islands, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[79] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including

[79] The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) repealed the estate tax for estates of decedents dying after December 31, 2009. However, EGTRRA included a “sunset” provision, pursuant to which EGTRRA’s provisions (including estate tax repeal) do not apply to estates of decedents dying after December 31, 2010.

the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of nonresident decedents who are not U.S. citizens. Under recent treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

## Description of Proposal

In general

Under the proposal, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had realized the excess directly. The proposal also provides that the estate of a foreign decedent is exempt from U.S. estate tax on a transfer of stock in the RIC in the proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the proposal, a RIC may, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

However, this exemption does not apply to a dividend on shares of RIC stock if the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption does not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally does not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor does the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original issue discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC-dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. However, in these two circumstances the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend is treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of: (1) the amount of qualified interest income of the RIC; over (2) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

If the amount designated as an interest-related dividend is greater than the qualified net interest income described above, the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Short-term capital gain dividends

Under the proposal, a RIC also may, under certain circumstances, designate all or a portion of a dividend as a "short-term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short-term capital gain dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption does not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. However, in this circumstance the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount qualified to be designated as short-term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in sec. 855) is equal to the excess of the RIC's net short-term capital gains over net long-term capital losses. The short-term capital gain includes short-term capital gain dividends from another RIC. As provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under sec. 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss is treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule also applies for purposes of computing the taxable income of the RIC.

In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. In addition, if the amount designated as short-term capital gain dividends is greater than the amount of qualified short-term capital gain, the portion of the distribution so designated which constitutes a short-term capital gain dividend is only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As under present law for distributions from REITs, the proposal provides that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The proposal also extends the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the proposal, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen is treated as property without the United States. The portion so treated is based upon the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets". Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

## Effective Date

The proposal generally applies to dividends with respect to taxable years of RICs beginning after December 31, 2004. With respect to the treatment of a RIC for estate tax purposes, the proposal applies to estates of decedents dying after December 31, 2004. With respect to the treatment of RICs under section 897 (relating to U.S. real property interests), the proposal is effective after December 31, 2004.

## 7. Taxation of certain settlement funds

### Present Law

In general, section 468B provides that a payment to a designated settlement fund that extinguishes a tort liability of the taxpayer will result in a deduction to the taxpayer. A designated settlement fund means a fund which is established pursuant to a court order, extinguishes the taxpayer's tort liability, is managed and controlled by persons unrelated to the taxpayer, and in which the taxpayer does not have a beneficial interest in the trust.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").

Present law provides that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

### Description of Proposal

The proposal clarifies that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed upon instructions by such government entity in accordance with applicable law. With regard to the last requirement, it is intended that, upon termination, any remaining funds will be disbursed to the government entity (e.g., the EPA) and used in accordance with applicable law.

### Effective Date

The proposal is effective for taxable years beginning after December 31, 2004.

**8. Expand human clinical trials expenses qualifying for the orphan drug tax credit**

## Present Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

## Description of Proposal

The proposal expands qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder, if certain conditions are met. Under the proposal, qualifying expenses include those expenses paid or incurred after the date on which the taxpayer files an application with the FDA for designation as a potential treatment for a rare disease or disorder if the drug receives FDA designation before the due date (including extensions) for filing the tax return for the taxable year in which the application was filed with the FDA. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

## Effective Date

The proposal is effective for expenditures paid or incurred after the date of enactment.

**9. Simplification of excise tax imposed on bows and arrows**

## Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.[80] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[81] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[82]

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[80] Sec. 4161(b)(1)(A).

[81] Sec. 4161(b)(2).

[82] Sec. 4161(b)(1)(B).

## Description of Proposal

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[83] The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the bill. In the case of any arrow comprised of a shaft or any other component upon which tax has been imposed, the amount of the arrow tax is equal to the excess of (1) the arrow tax that would have been imposed but for this exception, over (2) the amount of tax paid with respect to such components.[84] Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

## Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

### 10. Repeal excise tax on fishing tackle boxes

## Present Law

Under present law, a 10-percent manufacturer's excise tax is imposed on specified sport fishing equipment. Examples of taxable equipment include fishing rods and poles, fishing reels, artificial bait, fishing lures, line and hooks, and fishing tackle boxes. Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

## Description of Proposal

The proposal repeals the excise tax on fishing tackle boxes.

## Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

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[83] Draw weight is the maximum force required to bring the bowstring to a full-draw position not less than 26 1/4-inches, measured from the pressure point of the hand grip to the nocking position on the bowstring.

[84] A credit or refund may be obtained when an item was taxed and it is used in the manufacture or production of another taxable item. Sec. 6416(b)(3). As arrow components and finished arrows are both taxable, in lieu of a refund of the tax paid on components, the proposal suspends the application of sec. 6416(b)(3) and permits the taxpayer to reduce the tax due on the finished arrow by the amount of the previous tax paid on the components used in the manufacture of such arrow.

**11. Repeal of excise tax on sonar devices suitable for finding fish**

**Present Law**

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[85] A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.[86] Further, the tax imposed on the sale of sonar devices suitable for finding fish is limited to $30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.[87]

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

**Description of Proposal**

The proposal repeals the excise tax on all sonar devices suitable for finding fish.

**Effective Date**

The proposal is effective articles sold by the manufacturer, producer, or importer after December 31, 2004.

**12. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories**

**Present Law**

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. Tax on domestically produced and/or bottled distilled spirits arises upon production (receipt) in a bonded distillery and is collected based on removals from the distillery during each semi-monthly period. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. warehouse where they are landed (including a warehouse located in a foreign trade zone).

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

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[85] Sec. 4161(a)(1).

[86] Sec. 4161(a)(2).

[87] Sec. 4162(b).

## Description of Proposal

The proposal creates a new income tax credit for eligible wholesale distributors of distilled spirits. An eligible wholesaler is any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $22.83 per case of 12 750-milliliter bottles.

The credit only applies to domestically bottled distilled spirits[88] purchased directly from the bottler of such spirits. The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

The credit cannot be carried back to a taxable year beginning before January 1, 2005.

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2004.

### 13. Suspension of occupational taxes relating to distilled spirits, wine, and beer

## Present Law

Under present law, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory engine governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The present tax rates are as follows:

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|---|---|
| Producers[89]: | |
| Distilled spirits and wines (sec. 5081) | $1,000 per year, per premise |
| Brewers (sec. 5091) | $1,000 per year, per premise |
| Wholesale dealers (sec. 5111): | |
| Liquors, wines, or beer | $500 per year |

[88] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

[89] A reduced rate of tax in the amount of $500 is imposed on small proprietors. Secs. 5081(b), 5091(b).

| | |
|---|---|
| Retail dealers (sec. 5121): | |
| Liquors, wines, or beer | $250 per year |
| Nonbeverage use of distilled spirits (sec. 5131): | $500 per year |
| Industrial use of distilled spirits (sec. 5276): | $250 per year |

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.[90] A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.[91] There are penalties for failing to comply with the recordkeeping requirements.[92]

The Code limits the persons from whom dealers may purchase their liquor stock intended for resale. Under the Code, a dealer may only purchase from:

(1) a wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or

(2) a wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision chapter 51 of the Code; or

(3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[93]

Violation of this restriction is punishable by $1,000 fine, imprisonment of one year, or both.[94] A violation also makes the alcohol subject to seizure and forfeiture.[95]

## Description of Proposal

Under the proposal, the special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2004 through June 30, 2007. Present law recordkeeping and registration requirements will continue to apply, notwithstanding

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[90] Secs. 5114, 5124.

[91] Sec. 5146.

[92] Sec. 5603.

[93] Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office. Sec. 5113(a). Purchases from a State-operated liquor store would be covered under item (3). Sec. 5113(b).

[94] Sec. 5687.

[95] Sec. 7302.

the suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements.

**Effective Date**

The proposal is effective on the date of enactment.

# III. TAX REFORM AND SIMPLIFICATION FOR BUSINESSES BASED IN THE UNITED STATES

## A. Interest Expense Allocation Rules

### Present Law

**In general**

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[96] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.

**Affiliated group**

In general

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns.

Definition of affiliated group -- consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

[96] However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[97] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

## Description of Proposal

### In general

The proposal modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis

[97] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

(i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[98] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[99]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[100] as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[101] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

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[98] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account. It is anticipated that the Treasury Secretary will adopt regulations addressing the allocation and apportionment of interest expense on such indebtedness that follow principles analogous to those of existing regulations. Income from holding stock or indebtedness of another group member is taken into account for all purposes under the present-law rules of the Code, including the foreign tax credit provisions.

[99] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[100] The provision expands the definition of an affiliated group for interest expense allocation purposes to include certain insurance companies that are generally excluded from an affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)).

[101] Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

In addition, if an affiliated group elects to apply the new elective rules based on worldwide fungibility, the present-law rules regarding the treatment of tax-exempt assets and the basis of stock in nonaffiliated ten-percent owned corporations apply on a worldwide affiliated group basis.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

**Financial institution group election**

The proposal allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group. Under the provision, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[102] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the provision provides anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The provision provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, or address changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

[102] *See* Treas. Reg. sec. 1.904-4(e)(2).

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2008.

## B. Recharacterization of Overall Domestic Loss

### Present Law

The United States provides a credit for foreign income taxes paid or accrued. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income. This overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign-source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign-source income and, thus, the upper limit on the foreign tax credit for the year.

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the foreign tax credit used to offset the U.S. tax on income in each separate limitation category may not exceed the proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to its worldwide taxable income.

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess ("overall foreign loss," or "OFL") may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income.

In order to eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign-source income), present law includes an OFL recapture rule. Under this rule, a portion of foreign-source taxable income earned after an OFL year is recharacterized as U.S.-source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit). Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign-source taxable income earned in any particular taxable year is recharacterized as U.S.-source taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Losses for any taxable year in separate foreign limitation categories (to the extent that they do not exceed foreign income for the year) are apportioned on a proportionate basis among (and operate to reduce) the foreign income categories in which the entity earns income in the loss year. A separate limitation loss recharacterization rule applies to foreign losses apportioned to foreign income pursuant to the above rule. If a separate limitation loss was apportioned to income subject to another separate limitation category and the loss category has income for a subsequent taxable year, then that income (to the extent that it does not exceed the aggregate separate limitation losses in the loss category not previously recharacterized) must be recharacterized as income in the separate limitation category that was previously offset by the loss. Such recharacterization must be made in proportion to the prior loss apportionment not previously taken into account.

A U.S.-source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign-source income if viewed in isolation. The existence of foreign-source taxable income in the year of the U.S.-source loss reduces or eliminates any net operating loss carryover that the U.S.-source loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. Moreover, any U.S.-source loss for any taxable year is apportioned among (and operates to reduce) foreign income in the separate limitation categories on a proportionate basis. As a result, some foreign tax credits in the year of the U.S.-source loss must be credited, if at all, in a carryover year. Tax on U.S.-source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. There is currently no mechanism for recharacterizing such subsequent U.S.-source income as foreign-source income.

For example, suppose a taxpayer generates a $100 U.S.-source loss and earns $100 of foreign-source income in Year 1, and pays $30 of foreign tax on the $100 of foreign-source income. Because the taxpayer has no net taxable income in Year 1, no foreign tax credit can be claimed in Year 1 with respect to the $30 of foreign taxes. If the taxpayer then earns $100 of U.S.-source income and $100 of foreign-source income in Year 2, present law does not recharacterize any portion of the $100 of U.S.-source income as foreign-source income to reflect the fact that the previous year's $100 U.S.-source loss reduced the taxpayer's ability to claim foreign tax credits.

## Description of Proposal

The proposal applies a re-sourcing rule to U.S.-source income in cases in which a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss. Under the provision, a portion of the taxpayer's U.S.-source income for each succeeding taxable year is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized overall domestic losses for years prior to such succeeding taxable year, and (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.

The proposal defines an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the provision, an overall domestic loss does not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S.-source income recharacterized under the provision is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic losses, in a manner similar to the recharacterization rules for separate limitation losses.

It is anticipated that situations may arise in which a taxpayer generates an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The proposal grants the Secretary of the Treasury authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recapture rules added by the provision.

**Effective Date**

The proposal is effective for losses incurred in taxable years beginning after December 31, 2006.

## C. Reduction to Two Foreign Tax Credit Baskets

### Present Law

**In general**

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[103] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). In addition, a number of other provisions of the Code and U.S. tax treaties effectively create additional separate limitations in certain circumstances.[104]

**Financial services income**

In general, the term "financial services income" includes income received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, if the income is derived in the active conduct of a banking, financing or similar

[103] Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies that are not passive foreign investment companies (for pre-2003 earnings and profits). Under section 304 of the bill, these dividends are subject to a look-through approach, irrespective of when the underlying earnings and profits arose.

[104] *See, e.g.*, sec. 56(g)(4)(C)(iii)(IV) (relating to certain dividends from corporations eligible for the sec. 936 credit); sec. 245(a)(10) (relating to certain dividends treated as foreign source under treaties); sec. 865(h)(1)(B) (relating to certain gains from stock and intangibles treated as foreign source under treaties); sec. 901(j)(1)(B) (relating to income from certain specified countries); and sec. 904(g)(10)(A) (relating to interest, dividends, and certain other amounts derived from U.S.-owned foreign corporations and treated as foreign source under treaties).

business, or is derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business (sec. 904(d)(2)(C)). The Code also provides that financial services income includes income, received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, of a kind which would generally be insurance income (as defined in section 953(a)), among other items.

Treasury regulations provide that a person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any year if for that year at least 80 percent of its gross income is "active financing income."[105] The regulations further provide that a corporation that is not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business under the preceding definition can derive financial services income if the corporation is a member of an affiliated group (as defined in section 1504(a), but expanded to include foreign corporations) that, as a whole, meets the regulatory test of being "predominantly engaged."[106] In determining whether an affiliated group is "predominantly engaged," only the income of members of the group that are U.S. corporations, or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of the total voting power and value of the stock, are counted.

**"Base difference" items**

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[107] In cases in which foreign law imposes tax on an item of income that does not constitute income under U.S. tax principles (a "base difference" item), the tax is treated as imposed on income in the general limitation category.[108]

## Description of Proposal

**In general**

The proposal generally reduces the number of foreign tax credit limitation categories to two: passive category income and general category income. Other income is included in one of the two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation category, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation

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[105] Treas. Reg. sec. 1.904-4(e)(3)(i) and (2)(i).

[106] Treas. Reg. sec. 1.904-4(e)(3)(ii).

[107] Treas. Reg. sec. 1.904-6.

[108] Treas. Reg. sec. 1.904-6(a)(1)(iv).

category. The proposal does not affect the separate computation of foreign tax credit limitations under special provisions of the Code relating to, for example, treaty-based sourcing rules or specified countries under section 901(j).

**Financial services income**

In the case of a member of a financial services group or any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business, the proposal treats income meeting the definition of financial services income as general category income. Under the proposal, a financial services group is an affiliated group that is predominantly engaged in the active conduct of a banking, insurance, financing or similar business. For this purpose, the definition of an affiliated group under section 1504(a) is applied, but expanded to include certain insurance companies (without regard to whether such companies are covered by an election under section 1504(c)(2)) and foreign corporations. In determining whether such a group is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are U.S. corporations or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of total voting power and value of the stock are taken into account.

The proposal does not alter the present law interpretation of what it means to be a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business."[109] Thus, other provisions of the Code that rely on this same concept of a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" are not affected by the proposal. For example, under the "accumulated deficit rule" of section 952(c)(1)(B), subpart F income inclusions of a U.S. shareholder attributable to a "qualified activity" of a controlled foreign corporation may be reduced by the amount of the U.S. shareholder's pro rata share of certain prior year deficits attributable to the same qualified activity. In the case of a qualified financial institution, qualified activity consists of any activity giving rise to foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Similarly, in the case of a qualified insurance company, qualified activity consists of activity giving rise to insurance income or foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. For this purpose, "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" is defined under present law by reference to the use of the term for purposes of the separate foreign tax credit limitations.[110] The present-law meaning of "predominantly engaged" for purposes of section 952(c)(1)(B) remains unchanged under the proposal.

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[109] *See* Treas. Reg. sec. 1.904-4(e).

[110] *See* H.R. Rep. No. 99-841, 99$^{th}$ Cong., 2d Sess. II-621 (1986); Staff of the Joint Committee on Taxation, 100$^{th}$ Cong., 1$^{st}$ Sess., General Explanation of the Tax Reform Act of 1986, at 984 (1987).

The proposal requires the Treasury Secretary to specify the treatment of financial services income received or accrued by pass-through entities that are not members of a financial services group. It is anticipated that these regulations will be generally consistent with regulations currently in effect.

**<u>"Base difference" items</u>**

Creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed on general limitation income.

## <u>Effective Date</u>

The proposal is effective for taxable years beginning after December 31, 2006.

Taxes paid or accrued in a taxable year beginning before January 1, 2007, and carried to any subsequent taxable year are treated as if this proposal were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories, as appropriate.

The Treasury Secretary is given authority to provide by regulations for the allocation of income with respect to taxes carried back to pre-effective-date years (in which more than two limitation categories are in effect).

## D. Look-Through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations

### Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. In general, the amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are also applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).[111] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach).

For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

### Description of Proposal

The proposal generally applies the look-through approach to dividends paid by a 10/50 company regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.[112] If the Treasury Secretary determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 company to the proper foreign tax credit limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes.[113]

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[111] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate foreign tax credit limitation for each 10/50 company.

[112] This look-through treatment also applies to dividends that a controlled foreign corporation receives from a 10/50 company and then distributes to a U.S. shareholder.

[113] It is anticipated that the Treasury Secretary will reconsider the operation of the foreign tax credit regulations to ensure that the high-tax income rules apply appropriately to dividends treated as passive category income because of inadequate substantiation.

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

The proposal also provides transition rules regarding the use of pre-effective-date foreign tax credits associated with a 10/50-company separate limitation category in post-effective-date years. Look-through principles similar to those applicable to post-effective-date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. The proposal allows the Treasury Secretary to issue regulations addressing the carryback of foreign tax credits associated with a dividend from a 10/50 company to pre-effective-date years.

## E. Attribution of Stock Ownership Through Partnerships to Apply in Determining Section 902 and 960 Credits

### Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation is eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of the dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income taxes paid or accrued by lower-tier foreign corporations also are eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the domestic corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations (within the meaning of sec. 957) and the shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the controlled foreign corporations. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

Section 960 similarly permits a domestic corporation with subpart F inclusions from a controlled foreign corporation to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the controlled foreign corporation on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[114] In Rev. Rul. 71-141,[115] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations

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[114] Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued. In addition, under section 703(b)(3), the election under section 901 (whether to credit the foreign taxes) is made by each partner separately.

[115] 1971-1 C.B. 211.

through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[116] In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, uncertainty remains regarding whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

## Description of Proposal

The proposal clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The proposal also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

## Effective Date

The proposal applies to taxes of foreign corporations for taxable years of such corporations beginning after the date of enactment.

[116] T.D. 8708, 1997-1 C.B. 137.

### F. Foreign Tax Credit Treatment of Deemed Payments Under Section 367(d)

#### Present Law

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[117]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[118] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[119]

#### Description of Proposal

The proposal specifies that deemed payments under section 367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit.

#### Effective Date

The proposal is effective for amounts treated as received on or after August 5, 1997 (the effective date of the relevant provision of the 1997 Act).

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[117] Secs. 865(d), 862(a).

[118] Sec. 904(d).

[119] Sec. 904(d)(3).

## G. United States Property Not to Include Certain Assets of Controlled Foreign Corporation

### Present Law

In general, the subpart F rules[120] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year.[121]

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[122] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[123] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[124]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a

[120] Secs. 951-964.

[121] Sec. 951(a)(1)(B).

[122] Sec. 956(a).

[123] Secs. 956 and 959.

[124] Secs. 951(a)(1)(B) and 959.

secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[125]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[126]

## Description of Proposal

The proposal adds two new exceptions from the definition of U.S. property for determining current income inclusion by a U.S. 10-percent shareholder with respect to an investment in U.S. property by a controlled foreign corporation.

The first exception generally applies to securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a dealer in securities. The exception applies only if the controlled foreign corporation dealer: (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

The second exception generally applies to the acquisition by a controlled foreign corporation of obligations issued by a U.S. person that is not a domestic corporation and that is not (1) a U.S. 10-percent shareholder of the controlled foreign corporation, or (2) a partnership, estate or trust in which the controlled foreign corporation or any related person is a partner, beneficiary or trustee immediately after the acquisition by the controlled foreign corporation of such obligation.

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[125] Sec. 956(c)(1).

[126] Sec. 956(c)(2).

## Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

## H. Election Not to Use Average Exchange Rate for Foreign Tax Paid Other Than in Functional Currency

### Present Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate (sec. 986(a)(1)). This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period (sec. 986(a)(2)).

### Description of Proposal

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the proposal provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[127] Any election under the proposal applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The proposal authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

### Effective Date

The proposal is effective with respect to taxable years beginning after December 31, 2004.

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[127] Electing taxpayers translate foreign income tax payments pursuant to the same present-law rules that apply to taxpayers that are required to translate foreign income taxes using the exchange rates as of the time such taxes are paid.

## I. Repeal of Withholding Tax on Dividends From Certain Foreign Corporations

### Present Law

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend equivalent amount," which generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)).

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

### Description of Proposal

The proposal eliminates the secondary withholding tax with respect to dividends paid by certain foreign corporations.

### Effective Date

The proposal is effective for payments made after December 31, 2004.

## J. Provide Equal Treatment for Interest Paid by Foreign Partnerships and Foreign Corporations

**Present Law**

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[128] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[129] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[130]

**Description of Proposal**

The proposal treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The proposal applies only to foreign partnerships that are predominantly engaged in the active conduct of a trade or business outside the United States.

**Effective Date**

This proposal is effective for taxable years beginning after December 31, 2003.

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[128] Sec. 861(a)(1).

[129] Treas. Reg. sec. 1.861-2(a)(2).

[130] Sec. 884(f)(1).

## K. Look-Through Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Income Rules

### Present Law

In general, the rules of subpart F (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include certain income of the controlled foreign corporation (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

### Description of Proposal

Under the proposal, dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart-F income of the payor. For these purposes, a related controlled foreign corporation is a controlled foreign corporation that controls or is controlled by the other controlled foreign corporation, or a controlled foreign corporation that is controlled by the same person or persons that control the other controlled foreign corporation. Ownership of more than 50 percent of the controlled foreign corporation's stock (by vote or value) constitutes control for these purposes.

### Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

## L. Look-Through Treatment Under Subpart F for Sales of Partnership Interests

### Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends. Thus, if a controlled foreign corporation sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the controlled foreign corporation as subpart F income.

### Description of Proposal

The proposal treats the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly, indirectly, or constructively at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a controlled foreign corporation that meets this ownership threshold constitutes subpart F income under the proposal only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income. The Treasury Secretary is directed to prescribe such regulations as may be appropriate to prevent the abuse of this provision.

### Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

## M. Repeal of Foreign Personal Holding Company Rules and Foreign Investment Company Rules

### Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

Several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral rules are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple rules.

The Code sets forth the following anti-deferral rules: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1298); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (secs. 1246-1247).

### Description of Proposal

The bill: (1) eliminates the rules applicable to foreign personal holding companies and foreign investment companies; (2) excludes foreign corporations from the application of the personal holding company rules; and (3) includes as subpart F foreign personal holding company income personal services contract income that is subject to the present-law foreign personal holding company rules.

### Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## N. Determination of Foreign Personal Holding Company Income With Respect to Transactions in Commodities

### Present Law

**Subpart F foreign personal holding company income**

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, 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."

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 foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and real estate mortgage investment conduits ("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.

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[131] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of

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[131] For hedging transactions entered into on or after January 31, 2003, Treasury regulations provide that gains or losses from a commodities hedging transaction generally are excluded from the definition of foreign personal holding company income if the transaction is with respect to the controlled foreign corporation's business as a producer, processor, merchant or handler of commodities, regardless of whether the transaction is a hedge with respect to a sale of commodities in the active conduct of a commodities business by the controlled foreign corporation. The regulations also provide that, for purposes of satisfying the requirements for exclusion from the definition of foreign personal holding company income, a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business (Treas. Reg. sec. 1.954-2(f)(2)(v)). However, the regulations provide that a controlled foreign corporation is not a producer, processor, merchant or handler of commodities (and therefore would not satisfy the requirements for exclusion) if its business is primarily financial (Treas. Reg. sec. 1.954-2(f)(2)(v)).

commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[132]

**Hedging transactions**

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[133] The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations.[134]

## Description of Proposal

The proposal modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the proposal, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this proposal, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2).[135]

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[132] Treasury regulations provide that substantially all of a controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities if: (1) the sum of its gross receipts from all of its active sales of commodities in such capacity and its gross receipts from all of its commodities hedging transactions that qualify for exclusion from the definition of foreign personal holding company income, equals or exceeds (2) 85 percent of its total receipts for the taxable year (computed as though the controlled foreign corporation was a domestic corporation) (Treas. Reg. sec. 1.954-2(f)(2)(iii)(C)).

[133] Sec. 1221(a)(7).

[134] Sec. 1221(b)(2)(A).

[135] Sec. 1221(a)(7) and (b)(2)(B).

The proposal also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the proposal, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[136]

For purposes of applying the requirements for active business gains or losses from commodities sales to qualify for exclusion from the definition of foreign personal holding company income, the proposal also provides that commodities with respect to which gains or losses are not taken into account as foreign personal holding company income by a regular dealer in commodities (or financial instruments referenced to commodities) are not taken into account in determining whether substantially all of the dealer's commodities are comprised of the property described above.

## **Effective Date**

The proposal is effective with respect to transactions entered into after December 31, 2004.

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[136] For purposes of determining whether substantially all of the controlled foreign corporation's commodities are comprised of such property, it is intended that the 85-percent requirement provided in the current Treasury regulations (as modified to reflect the changes made by the proposal) continue to apply.

## O. Modifications to Treatment of Aircraft Leasing and Shipping Income

### Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include currently in income for U.S. tax purposes certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of their pro rata shares of the CFC's subpart F income. The amounts included in income by the CFC's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries. In addition, foreign base company shipping income includes dividends and interest that a CFC receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a CFC's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation.

Subpart F income also includes foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICS; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). The determination of whether rents or royalties are derived in the active conduct of a trade or business is based on all the facts and circumstances. However, the Treasury regulations provide certain types of rents are treated as derived in the active conduct of a trade or business. These include rents derived from property that is leased as a result of the performance of marketing functions by the lessor if the lessor, through its own officers or employees located in a foreign country, maintains and operates an organization in such country that regularly engages in the business of marketing, or marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property. An organization in a foreign country is substantial in relation to rents if the active leasing expenses[137] equal at least 25 percent of the adjusted leasing profit.[138]

Also generally excluded from subpart F foreign personal holding company income are rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC was organized (sec. 954(c)(3)). However, rent and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

## Description of Proposal

The proposal repeals the subpart F rules relating to foreign base company shipping income. The bill also amends the exception from foreign personal holding company income applicable to rents or royalties derived from unrelated persons in an active trade or business, by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. Such rents are excluded from foreign personal holding company income if the active leasing expenses comprise at least 10 percent of the profit on the lease. This proposal is to be applied in accordance with existing regulations under sec. 954(c)(2)(A) by comparing the lessor's "active leasing expenses" for its pool of leased assets to its "adjusted leasing profit."

The safe harbor will not prevent a lessor from otherwise showing that it actively carries on a trade or business. In this regard, the requirements of section 954(c)(2)(A) will be met if a lessor regularly and directly performs active and substantial marketing, remarketing, management and operational functions with respect to the leasing of an aircraft or vessel (or component engines). This will be the case regardless of whether the lessor engages in marketing of the lease as a form of financing (versus marketing the property as such) or whether the lease is classified as a finance lease or operating lease for financial accounting purposes. If a lessor acquires, from an unrelated or related party, a ship or aircraft subject to an existing FSC or ETI lease, the requirements of section 954(c)(2)(A) will be satisfied if, following the acquisition, the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property. If such a lease is transferred to a CFC lessor, it will no longer be eligible for FSC or ETI benefits.

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[137] "Active-leasing expenses" are section 162 expenses properly allocable to rental income other than (1) deductions for compensation for personal services rendered by the lessor's shareholders or a related person, (2) deductions for rents, (3) section 167 and 168 expenses, and (4) deductions for payments to independent contractors with respect to leased property. Treas. Reg. sec. 1.954-2(c)(2)(iii).

[138] Generally, "adjusted leasing profit" is rental income less the sum of (1) rents paid or incurred by the CFC with respect to such rental income; (2) section 167 and 168 expenses with respect to such rental income; and (3) payments to independent contractors with respect to such rental income. Treas. Reg. sec. 1.954-2(c)(2)(iv).

An aircraft or vessel will be considered to be leased in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and one in a foreign country or between foreign ports (or airports), provided the aircraft or vessel is used predominantly outside the United States. An aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is located outside the United States more than 50 percent of the time during such taxable year.

It is anticipated that the Secretary of the Treasury will issue timely guidance to make conforming changes to existing regulations, including guidance that aircraft or vessel leasing activity that satisfies the requirements of section 954(c)(2)(A) shall also satisfy the requirements for avoiding income inclusion under section 956 and section 367(a).

### Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## P. Modification of Exceptions Under Subpart F for Active Financing Income

### Present Law

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

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

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[139]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct

[139] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (P.L. No. 107-147) extended the temporary exceptions for five years, applicable only for taxable years beginning after 2001 and before 2007, with a modification relating to insurance reserves.

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

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

## Description of Proposal

The proposal modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the proposal provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country.

## Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## IV. EXTENSION OF CERTAIN EXPIRING PROVISIONS

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

#### Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[140] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit).

For taxable years beginning in 2003, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2003, the credits (other than the adoption credit, child credit and IRA credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of an exemption amount that phases out and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($58,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($40,250 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($29,000 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

#### Description of Proposal

The bill extends the provision allowing an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits for taxable years beginning in 2004 and 2005.

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

## **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

## B. Extension of the Research Credit

### Present Law

#### General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after June 30, 2004.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit (see sec. 41(e)).

#### Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent. In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenses.

#### Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[141] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a

[141] Sec. 41(c)(4).

base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

**Eligible expenses**

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[142]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which must constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (sec. 41(d)(4)). Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

**Relation to deduction**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a

[142] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

useful life extending beyond the current year must be capitalized.[143] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (Sec. 280C(c)). Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

**Description of Proposal**

The proposal extends the present-law research credit to qualified amounts paid or incurred before January 1, 2006.

**Effective Date**

The proposal is effective for amounts paid or incurred after the date of enactment.

[143] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

### C. Extension and Modification of the Section 45 Electricity Production Credit

#### Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt hour for 2004. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2004, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2004, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2004. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

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

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

#### Description of Proposal

The proposal extends the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities) and before January 1, 2006. The proposal does not extend the placed in service date for poultry waste facilities.

#### Effective Date

The proposal is effective for electricity produced and sold from qualifying facilities after December 31, 2003.

## D. Indian Employment Tax Credit

### Present Law

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An employee will not be treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (adjusted for inflation after 1993).

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2005.

### Description of Proposal

The proposal extends the Indian employment credit incentive for one year (to taxable years beginning before January 1, 2006).

### Effective Date

The proposal is effective on the date of enactment.

## E. Extend the Work Opportunity Tax Credit

### Present Law

**In general**

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

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

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

**Targeted groups eligible for the credit**

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

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

**Expiration date**

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

### Description of Proposal

The bill extends the work opportunity tax credit for two years (through December 31, 2005).

### Effective Date

The proposal is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2006.

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

### Present Law

**In general**

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

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

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

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

**Expiration date**

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

### Description of Proposal

The bill extends the welfare to work credit for two years (through December 31, 2005).

### Effective Date

The proposal is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2006.

### G. Extension of the Above-the-line Deduction for Certain Expenses of Elementary and Secondary School Teachers

**Present Law**

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $142,700 (for 2004). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning in 2002 and 2003, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2003.

**Description of Proposal**

The proposal extends the availability of the above-the-line deduction for two years, i.e., for taxable years beginning during 2004 and 2005.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003.

## H. Extension of Accelerated Depreciation Benefit for Property on Indian Reservations

### Present Law

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) will be determined using the following recovery periods:

| | |
|---|---|
| 3-year property.................................. | 2 years |
| 5-year property.................................. | 3 years |
| 7-year property.................................. | 4 years |
| 10-year property................................ | 6 years |
| 15-year property................................ | 9 years |
| 20-year property................................ | 12 years |
| Nonresidential real property.............. | 22 years |

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in service for purposes of conducting gaming activities. Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2005.

### Description of Proposal

The proposal extends the accelerated depreciation incentive for one year (to property placed in service before January 1, 2006).

### Effective Date

The proposal is effective on the date of enactment.

## I. Extend Enhanced Charitable Deduction for Computer Technology and Equipment

### Present Law

Under present law, a taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a qualified computer contribution.[144] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

A qualified computer contribution means a charitable contribution of any computer technology or equipment that meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[145] The original use of the property must be by the donor or the donee,[146] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. Property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.

### Description of Proposal

The proposal extends the enhanced deduction for qualified computer contributions to contributions made during any taxable year beginning before January 1, 2005.

### Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

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[144] Sec. 170(e)(6).

[145] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[146] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

## J. Extension of Expensing of Certain Environmental Remediation Costs

### <u>Present Law</u>

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

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory and (2) is at a site on which there has been a release (or threat of release) or disposal of certain hazardous substances as certified by the appropriate State environmental agency (so called "brownfields"). However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2004.

### <u>Explanation of Provision</u>

The bill extends the present-law expensing provision for two years (through December 31, 2005).

### <u>Effective Date</u>

The proposal is effective for expenses paid or incurred after December 31, 2003, and before January 1, 2006.

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

### **Present Law**

**In general**

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

**Eligible individuals**

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[147] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

**Tax treatment of and limits on contributions**

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

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

**Definition of high deductible plan**

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,600 in the case of individual coverage and at least $3,450 and no more than $5,150 in the case of family coverage. In addition, the maximum out-of-pocket expenses with

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

respect to allowed costs (including the deductible) must be no more than $3,450 in the case of individual coverage and no more than $6,300 in the case of family coverage.[148] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

**Cap on taxpayers utilizing Archer MSAs and expiration of pilot program**

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2003, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

Trustees of Archer MSAs are generally required to make reports to the Treasury by August 1 regarding Archer MSAs established by July 1 of that year. If any year is a cut-off year, the Secretary is to make and publish such determination by October 1 of such year.

## Description of Proposal

The proposal extends Archer MSAs through December 31, 2004. The proposal also provides that the reports required for 2004 are treated as timely if made within 90 days after the date of enactment.

## Effective Date

The proposal is generally effective on January 1, 2004. The proposal relating to reports is effective on the date of enactment.

[148] These dollar amounts are for 2004. These amounts are indexed for inflation, rounded to the nearest $50.

## L. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties

### Present Law

#### Overview of depletion

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

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[149] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

#### Cost depletion

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[150] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

#### Percentage depletion and related income limitations

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[151] Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.[152] The amount deducted generally may not exceed 100 percent

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

[150] Secs. 611-613.

[151] Sec. 613A.

[152] Sec. 613A(c).

of the net income from that property in any year (the "net-income limitation").[153] The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2004.

**Description of Proposal**

The suspension of the 100-percent net-income limitation for marginal wells is extended an additional two years, through taxable years beginning before January 1, 2006.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003.

[153] Sec. 613(a).

## M. Qualified Zone Academy Bonds

### Present Law

**Tax-exempt bonds**

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

**Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2003. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

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

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

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy", and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

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

## Description of Proposal

The bill authorizes issuance of up to $400 million of qualified zone academy bonds annually for calendar years 2004 and 2005.

## Effective Date

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

## N. Extension of Tax Incentives for Investment in the District of Columbia

### Present Law

**DC Zone incentives**

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The D.C. Zone designation is in effect for the period from January 1, 1998, through December 31, 2003. In addition to the tax incentives generally available with respect to empowerment zones, the D.C. Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Zone assets acquired after December 31, 1997, and held for more than five years.

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

**Homebuyers tax credit**

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for property purchased after December 31, 2003.

### Description of Proposal

**DC Zone incentives**

The bill extends the D.C. Zone designation and tax-exempt financing incentives for two years (through December 31, 2005). The bill extends the date before which a DC Zone asset must be acquired for purposes of utilizing the zero-percent capital gains rate for two years (to January 1, 2006), and extends the period within which gain is treated as qualified capital gain for two years (through December 31, 2010).

**Homebuyers tax credit**

The bill extends the first-time homebuyer credit for two years (through December 31, 2005).

## Effective Date

The proposals are effective on the date of enactment, except that the provision relating to tax-exempt financing incentives applies to obligations issued after December 31, 2003.

## O. Extend the Authority to Issue Liberty Zone Bonds

### Present Law

**In general**

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. For calendar year 2004, these annual volume limits are equal to the greater of $80 per resident of the State or $234 million.

**Tax-exempt private activity bonds**

Interest on private activity bonds is tax-exempt only for qualified bonds. Qualified bonds include: (1) exempt facility bonds; (2) qualified mortgage bonds; (3) qualified veteran mortgage bonds; (4) qualified small-issue bonds; (5) qualified student loan bonds; (6) qualified redevelopment bonds; and (7) qualified 501(c)(3) bonds. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Tax-exempt financing is also allowed for qualified New York Liberty Bonds issued during calendar years 2002, 2003, and 2004. An aggregate limit of $8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property[154] and residential rental real property[155] in a newly designated "Liberty Zone" (the

[154] No more than $800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery). The $800 million limit is divided equally between the Mayor and the Governor.

[155] No more than $1.6 billion of the authorized bond amount may be used to finance residential rental property. The $1.6 billion limit is divided equally between the Mayor and the Governor.

"Zone") of New York City is allowed.[156] Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,[157] and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the Zone. Issuance of these bonds is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to $4 billion of the bonds authorized under the bill.

If the Mayor or the Governor determines that it is not feasible to use all of the authorized bonds that he is authorized to designate for property located in the Zone, up to $1 billion of bonds may designated by each to be used for the acquisition, construction, and rehabilitation of nonresidential real property (including fixed tenant improvements) located outside the Zone and within New York City.[158] Bond-financed property located outside the Zone must meet the additional requirement that the project have at least 100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

(1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

(2) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));

(3) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (sec. 148(f)(4)(C));

(4) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violations of those

[156] Current refundings of outstanding New York Liberty Bonds bonds do not count against the $8 billion volume limit to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the bonds being refunded. In addition, qualified New York Liberty Bonds may be issued after December 31, 2004 to refund (other than advance refund) qualified New York Liberty Bonds originally issued before January 1, 2005, to the extent the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The bonds may not be advance refunded.

[157] Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

[158] Public utility property and residential property located outside the Zone cannot be financed with the bonds.

rules) do not apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));

(5) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds);[159] and

(6) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)).

## Description of Proposal

The proposal extends authority to issue New York Liberty Bonds through December 31, 2008.

## Effective Date

The proposal is effective for bonds issued after the date of enactment and before January 1, 2009.

[159] It is intended that redemptions will occur at least semi-annually beginning at the end of 10 years after the bonds are issued; however, amounts less than $250,000 are not required to be used to redeem bonds at such intervals.

### P. Disclosure to Law Enforcement Agencies Regarding Terrorist Activities

**Present Law**

Return information includes a taxpayer's identity.[160] The IRS may disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request. The request must be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.[161]

The Federal law enforcement agency may redisclose the information to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.[162] No disclosures may be made under this provision after December 31, 2003.

If a taxpayer's identity is taken from a return or other information filed with or furnished to the IRS by or on behalf of the taxpayer, it is taxpayer return information. Since taxpayer return information is not covered by this disclosure authorization, taxpayer identity so obtained cannot be disclosed and thus associated with the other information being provided.

**Description of Proposal**

The proposal extends the disclosure authority relating to terrorist activities. Under the proposal, no disclosures can be made after December 31, 2005.

The proposal makes a technical change to clarify that a taxpayer's identity is not treated as taxpayer return information for purposes of disclosures to law enforcement agencies regarding terrorist activities.

**Effective Date**

The proposal extending authority is effective for disclosures made on or after the date of enactment. The technical change is effective as if included in section 201 of the Victims of Terrorism Tax Relief Act of 2001.

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[160] Sec. 6103(b)(2)(A).

[161] Sec. 6103(i)(7)(A).

[162] Sec. 6103(i)(7)(A)(ii).

## Q. Disclosure of Return Information Relating to Student Loans

### Present Law

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[163] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[164] The Department of Education disclosure authority is scheduled to expire after December 31, 2004.[165]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[166] Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.[167] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[168]

### Description of Proposal

The bill extends the disclosure authority relating to the disclosure of return information to carry out income contingent repayment of student loans. Under the bill, no disclosures can be made after December 31, 2005.

### Effective Date

The proposal is effective with respect to disclosures made after the date of enactment.

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[163] Sec. 6103.

[164] Sec. 6103(l)(13).

[165] Pub. L. No. 108-89, sec. 201 (2003).

[166] Sec. 6103(c).

[167] Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (October 2000) at 91.

[168] Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003) at 133.

## R. Extension of Cover Over of Excise Tax on Distilled Spirits to Puerto Rico and Virgin Islands

### Present Law

A $13.50 per proof gallon[169] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[170] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[171]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[172] The amount of the cover over is limited under section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2003).

Thus, tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[173] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[174] All of the amounts covered over are subject to the limitation.

### Description of Proposal

The proposal temporarily suspends the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the proposal, the cover over amount of $13.25 per proof gallon is extended for rum brought into the United

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[169] A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10), (11).

[170] Sec. 5001(a)(1).

[171] Secs. 5062(b), 7653(b) and (c).

[172] Sec. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

[173] Sec. 7652(e)(2).

[174] Sec. 7652(a)(3), (b)(3), and (e)(1).

States after December 31, 2003 and before January 1, 2006. After December 31, 2005, the cover over amount reverts to $10.50 per proof gallon.

## Effective Date

The proposal is effective for articles brought into the United States after December 31, 2003.

## S. Extension of Joint Review

**Present Law**

The Code required the Joint Committee on Taxation to conduct a joint review[175] of the strategic plans and budget of the IRS from 1999 through 2003.[176] The Code also required the Joint Committee to provide an annual report[177] from 1999 through 2003 with respect to:

- Strategic and business plans for the IRS;
- Progress of the IRS in meeting its objectives;
- The budget for the IRS and whether it supports its objectives;
- Progress of the IRS in improving taxpayer service and compliance;
- Progress of the IRS on technology modernization; and
- The annual filing season.

**Description of Proposal**

The proposal requires that the Joint Committee conduct a joint review before June 1, 2005. The proposal requires the Joint Committee to provide an annual report before June 1, 2005, but specifies that the content of the annual report is the matters addressed in the joint review.[178]

**Effective Date**

The proposal is effective on the date of enactment.

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[175] The joint review was required to include two members of the majority and one member of the minority of the Senate Committees on Finance, Appropriations, and Governmental Affairs, and of the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight.

[176] Sec. 8021(f).

[177] Sec. 8022(3)(C).

[178] Accordingly, the proposal deletes the specific list of matters required to be covered in the annual report.

### T. Parity in the Application of Certain Limits to Mental Health Benefits

#### Present Law

The Mental Health Parity Act of 1996 amended the Employee Retirement Income Security Act of 1974 ("ERISA") and the Public Health Service Act ("PHSA") to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period. Since enactment, the mental health parity requirements in ERISA and the PHSA have been extended on more than one occasion and currently are scheduled to expire with respect to benefits for services furnished on or after December 31, 2004.

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

The Code provisions were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period.[179] The Code provisions have been extended on a number of occasions, and expired with respect to benefits for services furnished after December 31, 2003.

#### Description of Proposal

The proposal extends the Code provisions relating to mental health parity to benefits for services furnished after the date of enactment and before January 1, 2006. Thus, the excise tax on failures to meet the requirements imposed by the Code provisions does not apply after December 31, 2003, and before the date of enactment.

#### Effective Date

The proposal is effective for benefits for services furnished after the date of enactment.

[179] The excise tax does not apply to benefits for services furnished on or after September 30, 2001, and before January 10, 2002.

## U. Disclosure of Tax Information to Facilitate Combined Employment Tax Reporting

**Present Law**

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns.

The Taxpayer Relief Act of 1997[180] permitted implementation of a demonstration project to assess the feasibility and desirability of expanding combined Federal and State reporting. There were several limitations on the demonstration project. First, it was limited to the sharing of information between the State of Montana and the IRS. Second, it was limited to employment tax reporting. Third, it was limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it was limited to a period of five years.

The authority for the demonstration project expired on the date five years after the date of enactment (August 5, 2002).

**Description of Proposal**

The proposal renews authority for the demonstration project through December 31, 2005.

**Effective Date**

The proposal is effective on the date of enactment.

[180] Sec. 976; P.L. 105-34; August 5, 1997.

## V. Extension of Tax Credit for Electric Vehicles and Tax Deduction for Clean-Fuel Vehicles

### Present Law

#### Electric vehicles

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

#### Clean-fuel vehicles

Certain costs of qualified clean-fuel vehicle property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacity of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

### Description of Proposal

The proposal suspends the phase down of allowable tax credit for electric vehicles and the deduction for clean-fuel vehicles in 2004 and 2005. Thus, a taxpayer who purchases a qualifying vehicle may claim 100 percent of the otherwise allowable credit or deduction for vehicles purchased in 2004 and 2005. For vehicles purchased in 2006 the credit or deduction remains at 25 percent of the otherwise allowable amount as under present law.

### Effective Date

The proposal is effective for vehicles placed in service after December 31, 2003.

# V. DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

## A. Deduction of State and Local General Sales Taxes

### Present Law

An itemized deduction is permitted for certain taxes paid, including individual income taxes, real property taxes, and personal property taxes. No itemized deduction is permitted for State or local general sales taxes.

### Description of Proposal

The proposal provides that, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. The amount of the deduction would be required to be determined under tables prescribed by the Secretary. Such tables would be based on the average consumption by taxpayers, on a State by State basis, taking into account filing status, number of dependents, adjusted gross income, and rates of State and local general sales taxation.

The term 'general sales tax' means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items would not be taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax shall not be taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction shall be allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate shall be treated as the rate of tax.

A compensating use tax with respect to an item shall be treated as a general sales tax, provided such tax is complimentary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

### Effective Date

The proposal is effective for taxable years beginning after December 31, 2003 and prior to January 1, 2006.

## VI. REVENUE PROVISIONS

### A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation

#### 1. Tax treatment of expatriated entities and their foreign parents

**Present Law**

**Determination of corporate residence**

The U.S. tax treatment of a multinational corporate group depends significantly on whether the 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.

**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 (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). 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 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, a U.S. corporation may reincorporate in a foreign jurisdiction 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 (e.g., secs. 163(j) and 482).

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 secs. 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

The bill applies special tax rules to corporations that undertake certain defined inversion transactions. For this purpose, an 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 after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 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 conduct substantial business activities in the entity's country of incorporation compared to the total worldwide business activities of the expanded affiliated group.

In such a case, any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, 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 the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

In determining whether a transaction meets the definition of an inversion under the proposal, 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. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the proposal, 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 or a member of an expanded affiliated group. 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 proposal.

Under the proposal, inversion transactions include certain partnership transactions. Specifically, the proposal applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, 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.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

### Effective Date

The proposal applies to taxable years ending after March 4, 2003.

## 2. Excise tax on stock compensation of insiders in expatriated corporations

### Present Law

The income taxation of a nonstatutory[181] 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.[182] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.[183]

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

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[181] 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.

[182] 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.

[183] Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

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 proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 15-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 expatriation 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 expatriation 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,[184] 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)),[185] directors, and 10-percent-or-greater owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as previously defined in the bill) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction previously defined in the bill.

Specified stock compensation subject to the excise tax includes any payment[186] (or right to payment) granted by the expatriated corporation (or any member of the corporation's

[184] 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.

[185] 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.

[186] Under the proposal, 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.

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 a non-lapse restriction, 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 expatriating corporation (or member). For example, the proposal 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 if 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 would be 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 would be 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 proposal 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 expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues 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 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.

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, tax-sheltered annuity, simplified employee pension, or SIMPLE. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation 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 expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the proposal, 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 or 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 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 proposal. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can 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 expatriation transaction (or the date of cancellation or grant, if applicable). It is expected that the 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 and would be modified as necessary or appropriate to carry out the purposes of the provision. Pending the issuance of guidance, it is intended that taxpayers can rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the expatriated 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 Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance 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 proposal. 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 proposal, the Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the proposal.

**Effective Date**

The proposal is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

### 3. Reinsurance of U.S. risks in foreign jurisdictions

**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.[187] 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.[188] 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

[187] Sec. 845(a).

[188] See S. Rep. No. 97-494, 97th Cong., 2d Sess., 337 (1982) (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 bill 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 bill 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[189] 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 proposal is effective for any risk reinsured after the date of enactment of the proposal.

### 4. Revision of tax rules on expatriation of individuals

## Present Law

**In general**

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

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

**Income tax rules with respect to expatriates**

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[190] with a principal purpose of avoiding U.S. taxes, the individuals is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income [191] at the rates applicable to U.S. citizens for the 10-year period.

An individual who relinquishes citizenship or terminates residency is treated as having done so with a principal purpose of tax avoidance and is generally subject to the alternative tax regime if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[192] Certain categories of individuals (*e.g.*, dual residents) may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

**Estate tax rules with respect to expatriates**

Special estate tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the test above). Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets.

**Gift tax rules with respect to expatriates**

Special gift tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the rules above). The individual is subject to gift tax on

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[190] Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty).

[191] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[192] The income tax liability and net worth thresholds under section 877(a)(2) for 2004 are $124,000 and $622,000, respectively. *See* Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination.

**Information reporting**

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of expatriation. However, this information is only required once.

## Description of Proposal

**In general**

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination. [193]

**Objective rules for the alternative tax regime**

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax

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[193] These proposals reflect recommendations contained in Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003.

obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (*e.g.*, tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

**Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes**

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

**Sanction for individuals subject to the individual tax regime who return to the United States for extended periods**

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[194] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[195] and individuals with minimal prior physical presence in the United States,[196] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

**Imposition of gift tax with respect to stock of certain closely held foreign corporations**

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (*e.g.*, whether issued originally to the donor, purchased, or received as a gift or bequest).

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[194] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

[195] An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

[196] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

## Annual return

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

## Effective Date

The proposal applies to individuals who relinquish citizenship or terminate long-term residency after June 3, 2004.

### 5. Reporting of taxable mergers and acquisitions

## Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

## Description of Proposal

Under the bill, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[197]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements are extended to failures to comply with the requirements set forth under this bill.

### Effective Date

The proposal is effective for acquisitions after the date of enactment.

## 6. Studies

### Present Law

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's-length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration

[197] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

of the arm's-length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party transactions.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

## Description of Proposal

The bill requires the Secretary of the Treasury to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provision of this bill on inversion transactions.

## Effective Date

The tax treaty study required under the proposal is due no later than June 30, 2005. The transfer pricing study required under the proposal is due no later than June 30, 2005. The inversions study required under the proposal is due no later than December 31, 2005.

## B. Taxpayer-Related Proposals

### 1. Penalty for failing to disclose reportable transactions

#### Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[198]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[199] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[200]

The second category is any transaction that is offered under conditions of confidentiality. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[201]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[202]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20

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[198] On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

[199] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

[200] Treas. Reg. sec. 1.6011-4(b)(2).

[201] Treas. Reg. sec. 1.6011-4(b)(3).

[202] Treas. Reg. sec. 1.6011-4(b)(4).

million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[203]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[204] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[205]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[206]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure can jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[207]

## Description of Proposal

### In general

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

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[203] Treas. Reg. sec. 1.6011-4(b)(5). Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

[204] The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $250 million or more in gross assets.

[205] Treas. Reg. sec. 1.6011-4(b)(6). Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

[206] Treas. Reg. sec. 1.6011-4(b)(7).

[207] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. Regulations under sections 6662 and 6664 provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

**Transactions to be disclosed**

The proposal does not define the terms "listed transaction"[208] or "reportable transaction," nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

**Penalty rate**

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally. Thus, a revenue agent, an Appeals officer, or any other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

## Effective Date

The proposal is effective for returns and statements the due date for which is after the date of enactment.

### 2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose

## Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may

[208] The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[209] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[210]

Special rules apply with respect to tax shelters.[211] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[212] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[213]

## Description of Proposal

### In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[214] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

#### Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.

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[209] Sec. 6662.

[210] Sec. 6662(d)(2)(B).

[211] Sec. 6662(d)(2)(C).

[212] Sec. 6664(c).

[213] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[214] The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

**Determination of the understatement amount**

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of the proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return) [215], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

**Strengthened reasonable cause exception**

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[216] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item)

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[215] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to sec. 1211) be allowed for such year, shall be treated as an increase in taxable income.

[216] *See* the previous discussion regarding the penalty for failing to disclose a reportable transaction.

is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[217] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[218] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction.–A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[219] Participation in the "management" of a transaction

[217] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[218] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[219] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

**Coordination with other penalties**

Any understatement upon which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this provision shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

## Effective Date

The proposal is effective for taxable years ending after the date of enactment.

### 3. Tax shelter exception to confidentiality privileges relating to taxpayer communications

## Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

## Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

## Effective Date

The proposal is effective with respect to communications made on or after the date of enactment.

### 4. Statute of limitations for unreported listed transactions

## Present Law

In general, the Code requires that taxes be assessed within three years[220] after the date a return is filed.[221] If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[222] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[223]

## Description of Proposal

The proposal extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[224] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject extended statute of limitations.[225]

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[220] Sec. 6501(a).

[221] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[222] Sec. 6501(e).

[223] Sec. 6501(c).

[224] The term "listed transaction" has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

[225] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this proposal does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are

## Effective Date

The proposal is effective for taxable years with respect to which the period for assessing a deficiency did not expire before date of enactment.

### 5. Disclosure of reportable transactions by material advisors

## Present Law

**Registration of tax shelter arrangements**

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[226] A "tax shelter" means any investment with respect to which the tax shelter ratio[227] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and involving at least five investors).[228]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[229]

In general, a transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[230] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than

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recognized over multiple tax years, the proposal's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

[226] Sec. 6111(a).

[227] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[228] Sec. 6111(c).

[229] Sec. 6111(d).

[230] Treas. Reg. sec. 301.6111-2(b)(2).

one taxpayer.[231] Certain exceptions are provided with respect to the second category of transactions.[232]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[233]

**Failure to register tax shelter**

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[234] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

## Description of Proposal

**Disclosure of reportable transactions by material advisors**

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)[235] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

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[231] Treas. Reg. sec. 301.6111-2(b)(3).

[232] Treas. Reg. sec. 301.6111-2(b)(4).

[233] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

[234] Sec. 6707.

[235] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[236]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

**Penalty for failing to furnish information regarding reportable transactions**

The proposal repeals the present-law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[237] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.[238] All or part of the penalty may be rescinded only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only

[236] *See* the previous discussion regarding the disclosure requirements under new section 6707A.

[237] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

[238] The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.

be exercised by the Commissioner personally. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

**Effective Date**

The proposal requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

### 6. Investor lists and modification of penalty for failure to maintain investor lists

**Present Law**

**Investor lists**

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[239] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[240] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[241]

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[242] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially

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[239] Sec. 6112.

[240] Treas. Reg. sec. 301.6112-1.

[241] A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

[242] Treas. Reg. sec. 301.6112-1(c)(1).

abusive tax shelter.[243] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[244]

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.[245]

**Penalty for failing to maintain investor lists**

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

## Description of Proposal

**Investor lists**

Each material advisor[246] with respect to a reportable transaction (including a listed transaction)[247] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

The proposal also clarifies that, for purposes of section 6112, the identity of any person is not privileged for any purpose, such as either under the common law attorney-client privilege or under the section 7525 federally authorized tax practitioner rules.

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[243] Treas. Reg. sec. 301.6112-1(c)(2) and (3).

[244] Treas. Reg. sec. 301.6112-1(b).

[245] Sec. 6112(c)(2).

[246] The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

[247] The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related provisions.

**Penalty for failing to maintain investor lists**

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[248]

## Effective Date

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

The proposal clarifying that the identity of any person is not privileged for purposes of section 6112 is effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

### 7. Penalties on promoters of tax shelters

## Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[249] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A

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[248] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

[249] Sec. 6700.

penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

**Description of Proposal**

The proposal modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

**Effective Date**

The proposal is effective for activities after the date of enactment.

### 8. Modifications to the definition of the substantial understatement

**Present Law**

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[250]

**Description of Proposal**

The proposal modifies the definition of "substantial" for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.

**Effective Date**

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

[250] Sec. 6662(a) and (d)(1)(A).

### 9. Actions to enjoin conduct with respect to tax shelters and reportable transactions

#### Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[251]

#### Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[252] and the keeping of lists of investors by material advisors.[253] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

#### Effective Date

The proposal is effective on the day after the date of enactment.

### 10. Penalty for failure to report interests in foreign financial accounts

#### Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[254] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[255] In addition, any person who willfully violates this reporting requirement is subject to

[251] Sec. 7408.

[252] Sec. 6707, as amended by other provisions of this bill.

[253] Sec. 6708, as amended by other provisions of this bill.

[254] 31 U.S.C. 5314.

[255] 31 U.S.C. 5321(a)(5).

a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[256]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[257] This report, which was statutorily required,[258] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

**Description of Proposal**

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

**Effective Date**

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

### 11. Regulation of individuals practicing before the Department of the Treasury

**Present Law**

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[259] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

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[256] 31 U.S.C. 5322.

[257] *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

[258] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. No. 107-56).

[259] 31 U.S.C. 330.

## Description of Proposal

The proposal makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

The proposal also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

## Effective Date

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

### 12. Treatment of stripped interests in bond and preferred stock funds

## Present Law

**Assignment of income in general**

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[260]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed

[260] *Helvering v. Horst*, 311 U.S. 112 (1940).

below).[261] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[262]

**Stripped bonds**

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[263] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[264] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[265] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with

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[261] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 2003-55, 2003-34 I.R.B. 395, *modifying and superseding* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[262] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

[263] Sec. 1286.

[264] Sec. 1286(e).

[265] Sec. 1286(a).

the coupons attached) between the retained and disposed items.[266] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[267]

**Stripped preferred stock**

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[268] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[269] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[270]

## Description of Proposal

The bill authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as

[266] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

[267] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[268] Sec. 305(e)(5).

[269] Sec. 305(e)(1).

[270] Sec. 305(e)(3).

defined in section 305(e)(5)(B)), or any combination thereof. This provision applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,[271] *modifying and superseding* Rev. Proc. 2002-16.[272]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

## Effective Date

The proposal is effective for purchases and dispositions occurring after the date of enactment.

### 13. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends

## Present Law

In general, U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the

[271] 2002-43 I.R.B. 753.

[272] 2002-9 I.R.B. 572.

case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

## Description of Proposal

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the proposal. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

## Effective Date

The proposal is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

### 14. Disallowance of certain partnership loss transfers

## Present Law

**Contributions of property**

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[273] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[274] The contributing partner increases its basis in its partnership interest by the adjusted

[273] Sec. 721.

[274] Sec. 723.

basis of the contributed property.[275] Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[276] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.[277]

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.[278] If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

**Transfers of partnership interests**

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[279] If an election is in effect, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[280] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 is in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

**Distributions of partnership property**

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[281] In the case of a

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[275] Sec. 722.

[276] Sec. 704(c)(1)(A).

[277] If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for curative or remedial allocations to remedy this insufficiency. Treas. Reg. sec. 1.704-3(c) and (d).

[278] Treas. Reg. sec. 1.704-3(a)(7).

[279] Sec. 743(a).

[280] Sec. 743(b).

[281] Sec. 731(a) and (b).

distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[282] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[283]

The determination of the basis of individual properties distributed by a partnership is dependent on the adjusted basis of the properties in the hands of the partnership.[284] If a partnership interest is transferred to a partner and the partnership has not elected to adjust the basis of partnership property, a special basis rule provides for the determination of the transferee partner's basis of properties that are later distributed by the partnership.[285] Under this rule, in determining the basis of property distributed by a partnership within two years following the transfer of the partnership interest, the transferee may elect to determine its basis as if the partnership had adjusted the basis of the distributed property under section 743(b) on the transfer. The special basis rule also applies to distributed property if, at the time of the transfer, the fair market value of partnership property other than money exceeds 110 percent of the partnership's basis in such property and a liquidation of the partnership interest immediately after the transfer would have resulted in a shift of basis to property subject to an allowance of depreciation, depletion or amortization.[286]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[287] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[288] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the

[282] Sec. 732(b).

[283] Sec. 732(a).

[284] Sec. 732 (a)(1) and (c).

[285] Sec. 732(d).

[286] Treas. Reg. sec. 1.732-1(d)(4).

[287] Sec. 734(a).

[288] Sec. 734(b).

adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

## Description of Proposal

### Contributions of property

Under the proposal, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[289]

### Transfers of partnership interests

The proposal provides generally that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the bill, section 743(b) applies, so that a decrease is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

The bill provides that an electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. In lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. Under this rule, the transferee partner's distributive share of losses (determined without regard to gains) from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of such losses exceeds the loss recognized by the transferor partner. In the event of successive transfers, the transferee partner's distributive share of such losses is not allowed, except to the extent that it is established that such losses exceed the loss recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this rule). Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest. Thus, on subsequent sale or exchange of its partnership interest, such a partner's gain is reduced (or loss increased) because the basis of the partnership interest has not been reduced by such

[289] It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

losses. The proposal is applied without regard to any termination of a partnership under section 708(b)(1)(B). In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, the amount of the transferor's loss taken into account under this rule is reduced by the amount of the basis reduction.

For this purpose, an electing investment partnership means a partnership that satisfies the following requirements: (1) it makes an election under the provision that is irrevocable except with the consent of the Secretary; (2) it would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940[290] but for an exemption under paragraph (1) or (7) of section 3(c) of that Act; (3) it has never been engaged in a trade or business; (4) substantially all of its assets are held for investment; (5) at least 95 percent of the assets contributed to it consist of money; (6) no assets contributed to it had an adjusted basis in excess of fair market value at the time of contribution; (7) all partnership interests are issued by the partnership pursuant to a private offering and during the 24-month period beginning on the date of the first capital contribution to the partnership; (8) the partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and (9) the partnership agreement provides for a term that is not in excess of 15 years.

The proposal requires an electing investment partnership to furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule.

**<u>Distributions of partnership property</u>**

The proposal provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million, and that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C’s hands is $5 million. Under present law, C would recognize a loss of $4 million if the LMN stock were sold for $1 million.

Under the proposal, however, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than $250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by $2 million (the amount by which the basis of LMN stock was increased), leaving a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million.

[290] Section 3(a)(1)(A) provides, “when used in this title, 'investment company' means any issuer which is or hold itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”

## Effective Date

The proposal applies to contributions and distributions (as the case may be) after the date of enactment. The proposal generally applies to transfers after the date of enactment, except in the case of an electing investment partnership in existence on June 4, 2004, the requirement that the partnership agreement have substantive restrictions on redemptions does not apply, and the requirement that the partnership agreement provide for a term not exceeding 15 years is modified to permit a term not exceeding 20 years.

### 15. No reduction of basis under section 734 in stock held by partnership in corporate partner

## Present Law

### In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.[291] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[292] This includes current distributions and distributions in liquidation of a partner's interest.

### Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[293] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

### Election to adjust basis of partnership property

When a partnership distributes partnership property, the basis of partnership property generally is not adjusted to reflect the effects of the distribution or transfer. However, the partnership is permitted to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[294] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the

[291] Sec. 721(a).

[292] Sec. 731(a) and (b).

[293] Sec. 732(b).

[294] Sec. 754.

adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner and (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[295] In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[296]

## Description of Proposal

The proposal provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the proposal, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

## Effective Date

The proposal applies to distributions after the date of enactment.

### 16. Repeal of special rules for FASITs, etc.

## Present Law

### Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit

[295] Sec. 755(a).

[296] Sec. 755(b).

card receivables, home equity loans, and auto loans.[297] A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[298] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

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[297] Secs. 860H through 860L.

[298] Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

“Regular interests” of a FASIT

“Regular interests” of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest”, an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate (“AFR”) for the calendar month in which the instrument is issued.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT’s owner (or a person related to the FASIT’s owner), the property is treated as being first acquired by the FASIT’s owner for the FASIT’s cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules.–In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT’s assets and liabilities are treated as assets and liabilities of the FASIT’s owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT’s owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount (“OID”) accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

**Real estate mortgage investment conduits**

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[299] In order to qualify as a REMIC, substantially all of the assets of the entity must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

[299] *See* secs. 860A through 860G.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

## Description of Proposal

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the proposal also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the proposal modifies the present-law definition of a REMIC "regular interest" to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the proposal makes three modifications to the present-law definition of a "qualified mortgage." First, the proposal modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the proposal modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a "reverse mortgage loan" is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the proposal modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the proposal modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

**Effective Date**

Except as provided by the transition period for existing FASITs, this proposal is effective on January 1, 2005.

**17. Limitation on transfer of built-in losses on REMIC residuals**

**Present Law**

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[300] The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[301] The basis of property received by a controlled corporation in a tax-free transfer to the corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.[302]

**Description of Proposal**

The proposal provides that if a residual interest (as defined in section 860G(a)(2)) in a real estate mortgage investment conduit ("REMIC") is contributed to a corporation and the transferee corporation's adjusted basis in the REMIC residual interest would (but for the proposal) exceed the fair market value of the REMIC residual interest immediately after the contribution, the transferee corporation's adjusted basis in the REMIC residual interest is limited to the fair market value of the REMIC residual interest immediately after the contribution,

[300] Sec. 351.

[301] Sec. 358.

[302] Sec. 362(a).

regardless of whether the fair market value of the REMIC residual interest is less than, equal to, or greater than zero (i.e., the proposal may result in the transferee corporation having a negative adjusted basis in the REMIC residual interest).

## Effective Date

The proposal applies to transactions after the date of enactment.

### 18. Clarification of banking business for purposes of determining investment of earnings in U.S. property

## Present Law

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[303] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

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

The proposal provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with persons at least 80 percent of the income of which is derived in the active conduct of a banking business from unrelated persons. For purposes of applying this proposal, the deposit recipient and all persons related to the deposit recipient are treated as one person in applying the 80-percent test.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited*.

## <u>Effective Date</u>

This proposal is effective on the date of enactment.

[303] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

**19. Alternative tax for certain small insurance companies**

## Present Law

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (sec. 831(b)). For purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account (including gross receipts of foreign and tax-exempt corporations).

## Description of Proposal

Under the proposal, the $1.2 million ceiling on net written premiums or direct written premiums for purposes of the election to be taxed only on taxable investment income is increased to $1.89 million, and is indexed for taxable years beginning in a calendar year after 2004.

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

**20. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions**

## Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[304] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

## Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed listed transaction or from an undisclosed reportable transaction (other than a

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[304] Sec. 163(a).

listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.[305]

## Effective Date

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

### 21. Clarification of rules for payment of estimated tax for certain deemed asset sales

## Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

## Description of Proposal

The proposal clarifies section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the proposal, if a qualified stock purchase transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

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[305] The definitions of these transactions are the same as those previously described in connection with the proposal elsewhere in this bill to modify the accuracy-related penalty for listed and certain reportable transactions.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed based on an asset sale, computed from the date of the sale.

If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on the stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

### Effective Date

The proposal is effective for qualified stock purchase transactions that occur after the date of enactment.

## 22. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence

### Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[306] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

### Description of Proposal

The bill provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

### Effective Date

The proposal is effective for sales or exchanges of principal residences after the date of enactment.

[306] Sec. 121.

**23. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons**

## Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (secs. 951-964), the passive foreign investment company rules (secs. 1291-1298), and the foreign personal holding company rules (secs. 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[307] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[308] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[309]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[310] With respect to stated interest and other expenses owed to related foreign corporations, Treasury

[307] Sec. 163(e)(1).

[308] Sec. 163(e)(3).

[309] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue have in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[310] Sec. 267(a)(2).

regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[311] As in the case of OID, the Treasury regulations additionally provide that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[312]

**Description of Proposal**

The proposal provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules. Deductions that have accrued but are not allowable under this proposal are allowed when the amounts are paid.

For purposes of determining how much of the amount accrued, if any, is currently includible in the income of a U.S. person under the relevant inclusion rules, properly allowable deductions of the related foreign corporation and qualified deficits under section 952(c)(1)(B) are taken into account. For this purpose, properly allowable deductions of the related foreign corporation are those expenses, losses, or other deductible amounts of the foreign corporation that are properly allocable, under the principles of section 954(b)(5), to the relevant income of the foreign corporation.

For example, assume the following facts. A U.S. parent corporation accrues an expense item of 100 to its 60-percent owned CFC. The item constitutes foreign base company income in the hands of the CFC. An unrelated foreign corporation owns the remaining 40 percent interest in the CFC. The item is the only potential subpart F income of the CFC and has not been paid by the end of the taxable year of the parent. Expenses of 60 are properly allocated or apportioned to the 100 of foreign base company income under the principles of section 954(b)(5). In addition, other income and expense items of the CFC result in a loss of 30, which when taken together with the 40 (100 - 60) of net foreign base company income, results in current net income for the CFC of 10. Assuming further that the CFC has no current earnings and profits adjustments, the CFC's subpart F income in this case is limited to 10, six of which is includible in the gross income of the U.S. parent as its pro rata share of subpart F income. Under these facts, the U.S. parent is allowed a current deduction of 42 ((10 + 60) x 60%). If the other income and expense items of the CFC result in a loss of 50 instead of 30, the U.S. parent would instead be allowed a current deduction of 30 ((40 - 50 + 60) x 60%).

The proposal grants the Secretary regulatory authority to provide exceptions to these rules, including an exception for amounts accrued where payment of the amount accrued occurs

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[311] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[312] Treas. Reg. sec. 1.267(a)-3(c)(4).

within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged.

## Effective Date

The proposal is effective for payments accrued on or after date of enactment.

## 24. Exclusion from gross income for interest on overpayments of income tax by individuals

## Present Law

### Overpayment interest

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy. Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.

### Underpayment interest

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business." The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Fifth, Sixth, Seventh, Eighth, and Ninth Circuits.

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.

## Description of Proposal

The proposal excludes overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision is not considered disqualified income that could limit the earned income credit. Interest excluded under the provision also is not considered in determining what portion of a taxpayer's social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest does not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

It is expected that the Secretary will indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for the taxable year in which the underpayment interest is paid.

## Effective Date

The proposal is effective for interest received in calendar years beginning after the date of enactment.

### 25. Deposits made to suspend the running of interest on potential underpayments

## Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

## Description of Proposal

### In general

The proposal allows a taxpayer to deposit cash with the IRS that may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is deposited for the period that the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

**Use of a deposit to offset underpayments of tax**

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

**Withdrawal of amounts**

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

**Limitation on amounts for which interest may be allowed**

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

**Deposits are not payments of tax**

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

## Effective Date

The proposal applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

### 26. Authorize IRS to enter into installment agreements that provide for partial payment

## Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

## Description of Proposal

The proposal clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

## Effective Date

The proposal is effective for installment agreements entered into on or after the date of enactment.

### 27. Affirmation of consolidated return regulation authority

## Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[313]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[314]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[315]

In the recent case of *Rite Aid Corp. v. United States*,[316] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

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[313] Sec. 1501.

[314] Sec. 1502.

[315] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See,* S. Rep. No. 960, 70th Cong., 1st Sess. at 15 (1928), describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v. United States,* 1 Ct. Cl. 108 (1983), *aff'd*,726 F.2d 1569 (Fed. Cir. 1984), *cert. denied,* 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner,* 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

disallowance regulations, and concluded that the provision was invalid.[317] The particular provision, known as the "duplicated loss" provision,[318] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[319]

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[316] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[317] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States,* 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra. see also Union Carbide Corp. v. United States,* 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation,* 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc*., 293 U.S. 121 (1934), interpreting the term "taxable year."

[318] Treas. Reg. sec. 1.1502-20(c)(1)(iii).

[319] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[320]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[321] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [322]

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adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[320] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[321] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[322] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[323]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[324]

**Description of Proposal**

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate

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that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[323] *Rite Aid*, 255 F.3d at 1360.

[324] *See* Temp. Reg. sec. 1.1502-20T(i)(2), Temp. Reg. sec. 1.337(d)-2T, and Temp. Reg. sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002)T.D. 9048, 68 F.R. 12287 (March 14, 2003); and T.D. 9118, REG-153172-03 (March 17, 2004).

taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

*Rite Aid* is thus overruled to the extent it suggests that the Secretary is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision. The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, provided that such regulations are necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[325] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[326]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[327]

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[325] Treas. Reg. sec. 1.1502-20(c)(1)(iii).

[326] The provision is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. sec. 1.1502-20T(i)(2).

[327] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)); and T.D. 9118, REG-153172-03 (March 17, 2004). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

## Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is intended that the results following from this proposal are not the same as the results under present law.

### 28. Reform of tax treatment of certain leasing arrangements and limitation on deductions allocable to property used by governments or other tax-exempt entities

## Present Law

**Overview of depreciation**

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

**Characterization of leases for tax purposes**

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[328]

**Recovery period for tax-exempt use property**

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease

[328] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

term.[329] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term lease) to a tax-exempt entity.[330] For this purpose, the term "tax-exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[331]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[332] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[333]

Also, tax-exempt use property generally does not include qualified technological equipment that meets the exception for leases of high technology equipment to tax-exempt entities with lease terms of five years or less.[334] The recovery period for qualified technological equipment that is treated as tax-exempt use property, but is not subject to the high technology equipment exception, is five years.[335]

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[329] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

[330] Sec. 168(h)(1).

[331] Sec. 168(h)(2).

[332] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[333] Sec. 168(h)(1)(C).

[334] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[335] Sec. 168(g)(3)(C).

The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[336] In addition, tax-exempt use property does not include computer software because it is intangible property.

## Description of Proposal

### Overview

The proposal modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

### Modify the recovery period of certain property leased to a tax-exempt entity

The proposal modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity[337] to be the longer of the property's assigned class life or 125 percent of the lease term. The proposal does not apply to short-term leases, as defined under present law with a modification described below for short-term leases of qualified technological equipment.

### Modify definition of lease term

In determining the length of the lease term for purposes of the 125-percent calculation, the proposal provides that the lease term includes all service contracts (whether or not treated as a lease under section 7701(e)) and other similar arrangements that follow a lease of property to a tax-exempt entity and that are part of the same transaction (or series of transactions) as the lease. Under the proposal, service contracts and other similar arrangements include arrangements by which services are provided using the property in exchange for fees that provide a source of repayment of the capital investment in the property.[338] This requirement applies to all leases of property to a tax-exempt entity.

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[336] Sec. 168(i)(2).

[337] The proposal defines a tax-exempt entity as under present law. Thus, it includes Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

[338] For purposes of the proposal, a service contract does not include an arrangement for the provision of services if the leased property or substantially similar property is not utilized to provide such services. For example, if at the conclusion of a lease term, a tax-exempt lessee purchases property from the taxpayer and enters into an agreement pursuant to which the taxpayer maintains the property, the maintenance agreement will not be included in the lease term for purposes of the 125-percent computation.

**Expand short-term lease exception for qualified technological equipment**

For purposes of determining whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present-law 5-year short-term lease exception for leases of qualified technological equipment, the proposal provides that the term of the lease does not include an option or options of the lessee to renew or extend the lease, provided the rents under the renewal or extension are based upon fair market value determined at the time of the renewal or extension. The aggregate period of such renewals or extensions not included in the lease term under this provision may not exceed 24 months. In addition, this provision does not apply to any period following the failure of a tax-exempt lessee to exercise a purchase option if the result of such failure is that the lease renews automatically at fair market value rents.

**Limit deductions for leases of property to tax-exempt parties**

The proposal also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This provision does not apply to certain transactions involving property with respect to which the low-income housing credit or the rehabilitation credit is allowable.

This provision applies to deductions or losses related to a lease to a tax-exempt entity and the leased property.[339] Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year subject to the same limitations. Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all disposition gain or loss is recognized),[340] a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations of this provision if the lease satisfies all of the following requirements:[341]

(1) Tax-exempt lessee does not monetize its lease obligation

[339] Deductions related to a lease of tax-exempt use property include any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.

[340] *See* Sec. 469(g).

[341] Even if a transaction satisfies each of the following requirements, the taxpayer will be treated as the owner of the leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property under the present-law tax rules, including the benefits and burdens of ownership.

In general, the tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis[342] in the leased property at the time the lease is entered into.[343] Specifically, a lease does not satisfy this requirement if the tax-exempt lessee monetizes such excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or options under the lease. This determination shall be made at all times during the lease term and shall include the amount of any interest or other income or gain earned on any amount set aside or subject to an arrangement described in this provision. For purposes of determining whether amounts have been set aside or are expected to be set aside, amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that such amounts are set aside or expected to be set aside.[344]

The Secretary may provide by regulations that this requirement is satisfied, even if a tax-exempt lessee monetizes its lease obligations or options in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property, in cases in which the creditworthiness of the tax-exempt lessee would not otherwise satisfy the taxpayer's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's adjusted basis in the property. In addition, if the lease provides the tax-exempt lessee an option to purchase the property for a fixed purchase price (or for other than the fair market value of the property determined at the time of exercise of the option), such credit support at the time that such option may be exercised would not be permitted to exceed 50 percent of the purchase option price.

Certain circular lease transactions fail this requirement without regard to the amount by which the tax-exempt lessee monetizes its lease obligations or options. Thus, a lease does not satisfy this requirement if the tax-exempt lessee enters into an arrangement to monetize in any amount its lease obligations or options if such arrangement involves (1) a loan (other than an amount treated as a loan under section 467 with respect to a section 467 rental agreement) from

[342] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[343] Arrangements to monetize lease obligations include defeasance arrangements, loans by the tax-exempt entity (or an affiliate) to the taxpayer (or an affiliate) or any lender, deposit agreements, letters of credit collateralized with cash or cash equivalents, payment undertaking agreements, prepaid rent (within the meaning of the regulations under section 467), sinking fund arrangements, guaranteed investment contracts, financial guaranty insurance, or any similar arrangements.

[344] It is anticipated that the customary and budgeted funding by tax-exempt entities of unrestricted accounts or funds for general working capital needs or for the purpose of exercising a purchase option under a lease will not be considered arrangements, set-asides, or expected set-asides under this requirement.

the tax-exempt lessee to the taxpayer or a lender, (2) a deposit that is received, a letter of credit that is issued, or a payment undertaking agreement that is entered into by a lender otherwise involved in the transaction, or (3) in the case of a transaction that involves a lender, any credit support made available to the taxpayer in which any such lender does not have a claim that is senior to the taxpayer.

(2) Taxpayer maintains a substantial equity investment in property

The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis[345] in the leased property at that time,[346] (2) the taxpayer maintains such equity investment throughout the lease term (unless the lease term is 5 years or less), and (3) at all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis (unless the lease term is 5 years or less).[347] For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property.

(3) Tax-exempt lessee does not bear more than minimal risk of loss

The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease.[348] For this purpose, a tax-exempt lessee

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[345] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[346] The taxpayer's at-risk equity investment shall include only consideration paid, and personal liability incurred, by the taxpayer to acquire the property. *Cf.* Rev. Proc. 2001-28, 2001-2 C.B. 1156.

[347] *Cf.* Rev. Proc. 2001-28, sec. 4.01(2), 2001-1 C.B. 1156. The fair market value of the property must be determined without regard to inflation or deflation during the lease term and after subtracting the cost of removing the property.

[348] Examples of arrangements by which a tax-exempt lessee might assume or retain a risk of loss include put options, residual value guarantees, residual value insurance, and service contracts. However, leases do not fail to satisfy this requirement solely by reason of lease provisions that require the tax-exempt lessee to pay a contractually stipulated loss value to the taxpayer in the event of an early termination due to a casualty loss, a material default by the tax-exempt lessee (excluding the failure by the tax-exempt lessee to enter into an arrangement

assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination.[349] In addition, the Secretary may provide by regulations that this requirement is not satisfied where the tax-exempt lessee otherwise retains or assumes more than a minimal risk of loss. Such regulations shall be prospective only.

This requirement does not apply to leases with lease terms of 5 years or less.

Coordination with like-kind exchange and involuntary conversion rules

Under this provision, neither the like-kind exchange rules (sec. 1031) nor the involuntary conversion rules (sec. 1033) apply if either (1) the exchanged or converted property is tax-exempt use property subject to a lease that was entered into prior to the effective date of this provision and the lease would not have satisfied the requirements of this provision had such requirements been in effect when the lease was entered into, or (2) the replacement property is tax-exempt use property subject to a lease that does not meet the requirements of this provision.

Other rules

This provision continues to apply throughout the lease term to property that initially was tax-exempt use property, even if the property ceases to be tax-exempt use property during the lease term.[350] In addition, this provision is applied before the application of the passive activity loss rules under section 469.

This provision does not alter the treatment of any Qualified Motor Vehicle Operating Agreement within the meaning of section 7701(h). In the case of any such agreement, the second and third requirements provided by this provision (relating to taxpayer equity investment and tax-exempt lessee risk of loss, respectively) shall be applied without regard to any terminal rental adjustment clause.

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described above), or other similar extraordinary events that are not reasonably expected to occur at lease inception.

[349] For purposes of this requirement, residual value protection provided to the taxpayer by a manufacturer or dealer of the leased property is not treated as borne by the tax-exempt lessee if the manufacturer or dealer provides such residual value protection to customers in the ordinary course of its business.

[350] Conversely, however, a lease of property that is not tax-exempt use property does not become subject to this provision solely by reason of requisition or seizure by the Federal government in national emergency circumstances.

## **Effective Date**

The proposal generally is effective for leases entered into after March 12, 2004.[351] However, the proposal does not apply to property located in the United States that is subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2005, and (3) includes a description and the fair market value of such property.

The provisions relating to coordination with the like-kind exchange and involuntary conversion rules are effective with respect to property that is exchanged or converted after the date of enactment.

No inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date of this proposal. In addition, it is intended that this proposal shall not be construed as altering or supplanting the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property, including the benefits and burdens of ownership. This proposal also is not intended to affect the scope of any other present-law tax rules or doctrines applicable to purported leasing transactions.

[351] If a lease entered into on or before March 12, 2004, is transferred in a transaction that does not materially alter the terms of such lease, this proposal shall not apply to the lease as a result of such transfer.

## C. Reduction of Fuel Tax Evasion

### 1. Exemption from certain excise taxes for mobile machinery vehicles

**Present Law**

Under present law, the definition of a "highway vehicle" affects the application of the retail tax on heavy vehicles, the heavy vehicle use tax, the tax on tires, and fuel taxes.[352] Section 4051 of the Code provides for a 12-percent retail sales tax on tractors, heavy trucks with a gross vehicle weight ("GVW") over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 provides for a tax on highway vehicle tires that weigh more than 40 pounds, with higher rates of tax for heavier tires. Section 4481 provides for an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the Leaking Underground Storage Tank ("LUST") Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the LUST Trust Fund.

The Code does not define a "highway vehicle." For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for non-transportation functions (the "mobile machinery exception"); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the "off-highway transportation vehicle" exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance of non-transportation functions off the public highways.[353]

The mobile machinery exception applies if three tests are met: (1) the vehicle consists of a chassis to which jobsite machinery (unrelated to transportation) has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery; and (3) by reason of such special design, the chassis could not, without substantial structural modification, be used to transport a load other than the particular machinery. An example of a mobile machinery vehicle is a crane mounted on a truck chassis that meets the forgoing factors.

[352] Secs. 4051, 4071, 4481, 4041 and 4081.

[353] See Treas. Reg. sec. 48.4061-1(d).

On June 6, 2002, the Treasury Department put forth proposed regulations that would eliminate the mobile machinery exception.[354] The other exceptions from the definition of highway vehicle would continue to apply with some modifications. Under the proposed regulations, the chassis of a mobile machinery vehicle would be subject to the retail sales tax on heavy vehicles unless the vehicle qualified under the off-highway transportation vehicle exception. Also, under the proposed regulations, mobile machinery vehicles may be subject to the heavy vehicle use tax. In addition, the tax credits, refunds, and exemptions from tax may not be available for the fuel used in these vehicles.

## Description of Proposal

The proposal codifies the present-law mobile machinery exemption for purposes of three taxes: the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. Thus, if a vehicle can satisfy the three-part test, it will not be treated as a highway vehicle and will be exempt from these taxes.

For purposes of the fuel excise tax, the three-part design test is codified and a use test is added by the proposal. Specifically, in addition to the three-part design test, the vehicle must not have traveled more than 7,500 miles over public highways during the owner's taxable year. Refunds of fuel taxes are permitted on an annual basis only. For purposes of this rule, a person's taxable year is his taxable year for income tax purposes.

## Effective Date

The proposal generally is effective after the date of enactment. As to the fuel taxes, the proposal is effective for taxable years beginning after the date of enactment.

### 2. Taxation of aviation-grade kerosene

## Present Law

### In general

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.[355] Unlike other fuels that generally are taxed upon removal from a terminal rack,[356] aviation fuel is taxed upon sale of the fuel by a producer or importer.[357] Sales by a registered producer to another registered producer are exempt from tax, with the result that, as a practical matter, aviation fuel is not taxed until the fuel is used at the

[354] Prop. Treas. Reg. sec. 48.4051-1(a), 67 Fed. Reg. 38913, 38914-38915 (2002).

[355] Sec. 4093(a).

[356] A rack is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel. Treas. Reg. sec. 48.4081-1(b).

[357] Sec. 4091(a)(1).

airport. Use of untaxed aviation fuel by a producer is treated as a taxable sale.[358] The producer or importer is liable for the tax. The rate of tax on aviation fuel is 21.9 cents per gallon.[359]

The tax on aviation fuel is reported by filing Form 720 - Quarterly Federal Excise Tax Return. Generally, semi-monthly deposits are required using Form 8109B - Federal Tax Deposit Coupon or by depositing the tax by electronic funds transfer.

**Partial exemptions**

In general, aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.[360] Commercial aviation means any use of an aircraft in a business of transporting persons or property for compensation or hire by air (unless the use is allocable to any transportation exempt from certain excise taxes).[361]

In order to qualify for the 4.4 cents per gallon rate, the person engaged in commercial aviation must be registered with the Secretary[362] and provide the seller with a written exemption certificate stating the airline's name, address, taxpayer identification number, registration number, and intended use of the fuel. A person that is registered as a buyer of aviation fuel for use in commercial aviation generally is assigned a registration number with a "Y" suffix (a "Y" registrant), which entitles the registrant to purchase aviation fuel at the 4.4 cents per gallon rate.

Large commercial airlines that also are producers of aviation fuel qualify for registration numbers with an "H" suffix. As producers of aviation fuel, "H" registrants may buy aviation fuel tax free pursuant to a full exemption that applies to sales of aviation fuel by a registered producer to a registered producer. If the "H" registrant ultimately uses such untaxed fuel in domestic commercial aviation, the H registrant is liable for the aviation fuel tax at the 4.4 cents per gallon rate.

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[358] Sec. 4091(a)(2).

[359] Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) & 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

[360] Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), & 4221(d)(3).

[361] Secs. 4092(b) & 4041(c)(2).

[362] Form 637 - Application for Registration (For Certain Excise Tax Activities). A bond may be required as a condition of registration.

## Exemptions

Aviation fuel sold by a producer or importer for use by the buyer in a nontaxable use is exempt from the excise tax on sales of aviation fuel.[363] To qualify for the exemption, the buyer must provide the seller with a written exemption certificate stating the buyer's name, address, taxpayer identification number, registration number (if applicable), and intended use of the fuel.

Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions;[364] (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing aircraft for purposes of providing transportation with respect to which certain requirements are met.[365]

A producer that is registered with the Secretary may sell aviation fuel tax-free to another registered producer.[366] Producers include refiners, blenders, wholesale distributors of aviation fuel, dealers selling aviation fuel exclusively to producers of aviation fuel, the actual producer of the aviation fuel, and with respect to fuel purchased at a reduced rate, the purchaser of such fuel.

## Refunds and credits

A claim for refund of taxed aviation fuel held by a registered aviation fuel producer is allowed[367] (without interest) if: (1) the aviation fuel tax was paid by an importer or producer (the "first producer") and the tax has not otherwise been credited or refunded; (2) the aviation fuel was acquired by a registered aviation fuel producer (the "second producer") after the tax was paid; (3) the second producer files a timely refund claim with the proper information; and (4) the first producer and any other person that owns the fuel after its sale by the first producer and before its purchase by the second producer have met certain reporting requirements.[368] Refund

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[363] Sec. 4092(a).

[364] "Trade" includes the transportation of persons or property for hire. Treas. Reg. sec. 48.4221-4(b)(8).

[365] Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 4092.

[366] Sec. 4092(c).

[367] Sec. 4091(d).

[368] Treas. Reg. sec. 48.4091-3(b).

claims should contain the volume and type of aviation fuel, the date on which the second producer acquired the fuel, the amount of tax that the first producer paid, a statement by the claimant that the amount of tax was not collected nor included in the sales price of the fuel by the claimant when the fuel was sold to a subsequent purchaser, the name, address, and employer identification number of the first producer, and a copy of any required statement of a subsequent seller (subsequent to the first producer but prior to the second producer) that the second producer received. A claim for refund is filed on Form 8849, Claim for Refund of Excise Taxes, and may not be combined with any other refunds.[369]

A payment is allowable to the ultimate purchaser of taxed aviation fuel if the aviation fuel is used in a nontaxable use.[370] A claim for payment may be made on Form 8849 or on Form 720, Schedule C. A claim made on Form 720, Schedule C, may be netted against the claimant's excise tax liability.[371] Claims for payment not so taken may be allowable as income tax credits[372] on Form 4136, Credit for Federal Tax Paid on Fuels.

## Description of Proposal

The proposal changes the incidence of taxation of aviation fuel from the sale of aviation fuel to the removal of aviation fuel from a refinery or terminal, or the entry into the United States of aviation fuel. Sales of not previously taxed aviation fuel to an unregistered person also are subject to tax.

Under the proposal, the full rate of tax -- 21.9 cents per gallon -- is imposed upon removal of aviation fuel from a refinery or terminal (or entry into the United States). Aviation fuel may be removed at a reduced rate -- either 4.4 or zero cents per gallon -- only if the aviation fuel is: (1) removed directly into the wing of an aircraft (i) that is registered with the Secretary as a buyer of aviation fuel for use in commercial aviation (e.g., a "Y" registrant under current law), (ii) that is a foreign airline entitled to the present law exemption for aviation fuel used in foreign trade, or (iii) for a tax-exempt use; or (2) removed or entered as part of an exempt bulk transfer.[373] An exempt bulk transfer is a removal or entry of aviation fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the aviation fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.

Under a special rule, the proposal treats certain refueler trucks, tankers, and tank wagons as a terminal if certain requirements are met. For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation fuel from a terminal: (1) that is located

[369] Treas. Reg. sec. 48.4091-3(d)(1).

[370] Sec. 6427(l)(1).

[371] Treas. Reg. sec. 40.6302(c)-1(a)(3).

[372] Sec. 34.

[373] See sec. 4081(a)(1)(B).

within an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. It is intended that a terminal is located within an airport if the terminal is located in a secure facility on airport grounds. For example, if an access road runs between a terminal and an airport's runways, and the terminal, like the runways, is physically located on airport grounds and is part of a secure facility, it is intended that under the proposal the terminal is located within the airport. It is intended that an exigent circumstance under which loading a vehicle registered for highway use with fuel would not disqualify a terminal under the special rule, includes, for example, the unloading of fuel from bulk storage tanks into highway vehicles in order to repair the storage tanks.

In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) deliver the aviation fuel directly into the wing of the aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be licensed for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.[374]

The proposal does not change the applicable rates of tax under present law, 21.9 cents per gallon for use in noncommercial aviation, 4.4 cents per gallon for use in commercial aviation, and zero cents per gallon for use by domestic airlines in an international flight, by foreign airlines, or other nontaxable use. The proposal imposes liability for the tax on aviation fuel removed from a refinery or terminal directly into the wing of an aircraft for use in commercial aviation on the person receiving the fuel, in which case, such person self-assesses the tax on a return. The proposal does not change present-law nontaxable uses of aviation fuel, or change the persons or the qualifications of persons who are entitled to purchase fuel at a reduced rate, except that a producer is not permitted to purchase aviation fuel at a reduced rate by reason of such persons' status as a producer.

Under the proposal, a refund is allowable to the ultimate vendor of aviation fuel if such ultimate vendor purchases fuel tax paid and subsequently sells the fuel to a person qualified to purchase at a reduced rate and who waives the right to a refund. In such a case, the proposal permits an ultimate vendor to net refund claims against any excise tax liability of the ultimate vendor, in a manner similar to the present law treatment of ultimate purchaser payment claims.

As under present law, if previously taxed aviation fuel is used for a nontaxable use, the ultimate purchaser may claim a refund for the tax previously paid. If previously taxed aviation fuel is used for a taxable non aircraft use, the fuel is subject to the tax imposed on kerosene (24.4 cents per gallon) and a refund of the previously paid aviation fuel tax is allowed. Claims by the ultimate vendor or the purchaser that are not taken as refund claims may be allowable as income tax credits.

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[374] The proposal requires that if such delivery of information is provided to a terminal operator (or if a terminal operator collects such information), that the terminal operator provide such information to the Secretary.

For example, for an airport that is not served by a pipeline, aviation fuel generally is removed from a terminal and transported to an airport storage facility for eventual use at the airport. In such a case, the aviation fuel will be taxed at 21.9 cents per gallon upon removal from the terminal. At the airport, if the fuel is purchased from a vendor by a person registered with the Secretary to use fuel in commercial aviation, the purchaser may buy the fuel at a reduced rate (generally, 4.4 cents per gallon for domestic flights and zero cents per gallon for international flights) and waive the right to a refund. The ultimate vendor generally may claim a refund for the difference between 21.9 cents per gallon of tax paid upon removal and the rate of tax paid to the vendor by the purchaser. To obtain a zero rate upon purchase, a registered domestic airline must certify to the vendor at the time of purchase that the fuel is for use in an international flight; otherwise, the airline must pay the 4.4 cents per gallon rate and file a claim for refund to the Secretary if the fuel is used for international aviation. If a zero rate is paid and the fuel subsequently is used in domestic and not international travel, the domestic airline is liable for tax at 4.4 cents per gallon. A foreign airline eligible under present law to purchase aviation fuel tax-free would continue to purchase such fuel tax-free.

As another example, for an airport that is served by a pipeline, aviation fuel generally is delivered to the wing of an aircraft either by a refueling truck or by a "hydrant" that runs directly from the pipeline to the airplane wing. If a refueling truck that is not licensed for highway use loads fuel from a terminal located within the airport (and the other requirements of the proposal for such truck and terminal are met), and delivers the fuel directly to the wing of an aircraft for use in commercial aviation, the aviation fuel is taxed at 4.4 cents per gallon upon delivery to the wing and the person receiving the fuel is liable for the tax, which such person would be able to self-assess on a return.[375] If fuel is loaded into a refueling truck that does not meet the requirements of the proposal, then the fuel is treated as removed from the terminal into the refueling truck and tax of 21.9 cents per gallon is paid on such removal. The ultimate vendor is entitled to a refund of the difference between 21.9 cents per gallon paid on removal and the rate paid by a commercial airline purchaser (assuming the purchaser waived the refund right). If fuel is removed from a terminal directly to the wing of an aircraft registered to use fuel in commercial aviation by a hydrant or similar device, the person removing the aviation fuel is liable for a tax of 4.4 cents per gallon (or zero in the case of an international flight or qualified foreign airline) and may self-assess such tax on a return.

Under the proposal, a floor stocks tax applies to aviation fuel held by a person (if title for such fuel has passed to such person) on October 1, 2004. The tax is equal to the amount of tax that would have been imposed before October 1, 2004, if the proposal was in effect at all times before such date, reduced by the tax imposed by section 4091, as in effect on the day before the date of enactment. The Secretary shall determine the time and manner for payment of the tax, including the nonapplication of the tax on de minimis amounts of aviation fuel. Under the proposal, 0.1 cents per gallon of such tax is transferred to the LUST Trust Fund. The remainder is transferred to the Airport and Airway Trust Fund.

[375] Alternatively, if the aviation fuel in the example is for use in noncommercial aviation, the fuel is taxed at 21.9 cents per gallon upon delivery into the wing. Self-assessment of the tax would not apply in such case.

## Effective Date

The proposal is effective for aviation fuel removed, entered, or sold after September 30, 2004.

### 3. Mechanical dye injection and related penalties

## Present Law

### Statutory rules

Gasoline, diesel fuel and kerosene are generally subject to excise tax upon removal from a refinery or terminal, upon importation into the United States, and upon sale to unregistered persons unless there was a prior taxable removal or importation of such fuels.[376] However, a tax is not imposed upon diesel fuel or kerosene if all of the following are met: (1) the Secretary determines that the fuel is destined for a nontaxable use, (2) the fuel is indelibly dyed in accordance with regulations prescribed by the Secretary,[377] and (3) the fuel meets marking requirements prescribed by the Secretary.[378] A nontaxable use is defined as (1) any use that is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax, (2) any use in a train, or (3) certain uses in buses for public and school transportation, as described in section 6427(b)(1) (after application of section 6427(b)(3)).[379]

The Secretary is required to prescribe necessary regulations relating to dyeing, including specifically the labeling of retail diesel fuel and kerosene pumps.[380]

A person who sells dyed fuel (or holds dyed fuel for sale) for any use that such person knows (or has reason to know) is a taxable use, or who willfully alters or attempts to alter the dye

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[376] Sec. 4081(a)(1)(A). If such fuel is used for a nontaxable purpose, the purchaser is entitled to a refund of tax paid, or in some cases, an income tax credit. *See* sec. 6427.

[377] Dyeing is not a requirement, however, for certain fuels under certain conditions, i.e., diesel fuel or kerosene exempted from dyeing in certain States by the EPA under the Clean Air Act, aviation-grade kerosene as determined under regulations prescribed by the Secretary, kerosene received by pipeline or vessel and used by a registered recipient to produce substances (other than gasoline, diesel fuel or special fuels), kerosene removed or entered by a registrant to produce such substances or for resale, and (under regulations) kerosene sold by a registered distributor who sells kerosene exclusively to ultimate vendors that resell it (1) from a pump that is not suitable for fueling any diesel-powered highway vehicle or train, or (2) for blending with heating oil to be used during periods of extreme or unseasonable cold. Sec. 4082(c), (d).

[378] Sec. 4082(a).

[379] Sec. 4082(b).

[380] Sec. 4082(e).

in any dyed fuel, is subject to a penalty.[381] The penalty also applies to any person who uses dyed fuel for a taxable use (or holds dyed fuel for such a use) and who knows (or has reason to know) that the fuel is dyed.[382] The penalty is the greater of $1,000 per act or $10 per gallon of dyed fuel involved. In determining the amount of the penalty, the $1,000 is increased by the product of $1,000 and the number of prior penalties imposed upon such person (or a related person or predecessor of such person or related person).[383] The penalty may be imposed jointly and severally on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty.[384] For purposes of the penalty, the term "dyed fuel" means any dyed diesel fuel or kerosene, whether or not the fuel was dyed pursuant to section 4082.[385]

**Regulations**

The Secretary has prescribed certain regulations under this provision, including regulations that specify the allowable types and concentration of dye, that the person claiming the exemption must be a taxable fuel registrant, that the terminal must be an approved terminal (in the case of a removal from a terminal rack), and the contents of the notice to be posted on diesel fuel and kerosene pumps.[386] However, the regulations do not prescribe the time or method of adding the dye to taxable fuel.[387] Diesel fuel is usually dyed at a terminal rack by either manual dyeing or mechanical injection.

## Description of Proposal

With respect to terminals that offer dyed fuel, the proposal eliminates manual dyeing of fuel and requires dyeing by a mechanical system. Not later than 180 days after enactment of this proposal, the Secretary of the Treasury is to prescribe regulations establishing standards for tamper resistant mechanical injector dyeing. Such standards shall be reasonable, cost-effective, and establish levels of security commensurate with the applicable facility.

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[381] Sec. 6715(a).

[382] Sec. 6715(a).

[383] Sec. 6715(b).

[384] Sec. 6715(d).

[385] Sec. 6715(c)(1).

[386] Treas. Reg. secs. 48.4082-1, -2.

[387] In March 2000, the IRS withdrew its Notice of Proposed Rulemaking PS-6-95 (61 F.R. 10490 (1996)) relating to dye injection systems. Announcement 2000-42, 2000-1 C.B. 949. The proposed regulation established standards for mechanical dye injection equipment and required terminal operators to report nonconforming dyeing to the IRS. *See also* Treas. Reg. sec. 48.4082-1(c), (d).

The proposal adds an additional set of penalties for violation of the new rules. A penalty, equal to the greater of $25,000 or $10 for each gallon of fuel involved, applies to each act of tampering with a mechanical dye injection system. The person committing the act is also responsible for any unpaid tax on removed undyed fuel. A penalty of $1,000 is imposed for each failure to maintain security for mechanical dye injection systems. An additional penalty of $1,000 is imposed for each day any such violation remains uncorrected after the first day such violation has been or reasonably should have been discovered. For purposes of the daily penalty, a violation may be corrected by shutting down the portion of the system causing the violation. If any of these penalties are imposed on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty. If such business entity is part of an affiliated group, the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty.

**Effective Date**

The proposal requiring the use of mechanical dye injection systems and imposing penalties is effective 180 days after the date that the Secretary issues the required regulations. The Secretary must issue such regulations no later than 180 days after enactment.

### 4. Authority to inspect on-site records

**Present Law**

The Internal Revenue Service is authorized to inspect any place where taxable fuel is produced or stored (or may be stored). The inspection is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[388]

In conducting the inspection, the Internal Revenue Service may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept at the place of inspection to determine the excise tax liability under section 4081.[389]

**Description of Proposal**

The proposal expands the scope of the inspection to include any books, records or shipping papers pertaining to taxable fuel at the place of inspection.

[388] Sec. 4083(c)(1)(A).

[389] Treas. Reg. sec. 48.4083-1(c)(1).

## Effective Date

The proposal is effective on the date on enactment.

### 5. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries

## Present Law

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[390] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") to a terminal or refinery if both the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[391]

Present law does not require that the vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered refiner may transfer fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer to an unregistered person.

In general, the owner of the fuel is liable for payment of tax with respect to bulk transfers not received at an approved terminal or refinery.[392] The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.[393]

## Description of Proposal

The proposal requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax.

The Secretary is required to publish periodically a list of all registered persons who are required to register.

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[390] Sec. 4081(a)(1)(A).

[391] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

[392] Treas. Reg. sec. 48.4081-3(e)(2).

[393] Treas. Reg. sec. 48.4081-3(b).

### Effective Date

The proposal is effective on October 1, 2004, except that the Secretary is required to publish the list of registered persons beginning on July 1, 2004.

**6. Display of registration and penalties for failure to display registration and to register**

### Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[394] A non assessable penalty for failure to register is $50.[395] A criminal penalty of $5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[396]

### Description of Proposal

The proposal requires that every operator of a vessel who is required to register with the Secretary display on each vessel used by the operator to transport fuel, proof of registration through an electronic identification device prescribed by the Secretary. A failure to display such proof of registration results in a penalty of $500 per month per vessel. The amount of the penalty is increased for multiple prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

The proposal imposes a new assessable penalty for failure to register of $10,000 for each initial failure, plus $1,000 per day that the failure continues. No penalty is imposed upon a showing by the taxpayer of reasonable cause. In addition, the proposal increases the present law non assessable penalty for failure to register from $50 to $10,000 and the present law criminal penalty for failure to register from $5,000 to $10,000. The proposal authorizes amounts equivalent to any of such penalties received to be appropriated to the Highway Trust Fund.

### Effective Date

The proposal requiring display of registration is effective on October 1, 2004. The proposal relating to penalties is effective for penalties imposed after September 30, 2004.

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[394] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

[395] Sec. 7272(a).

[396] Sec. 7232.

**7. Penalties for failure to report**

## Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.[397] Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[398] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements. In general, the penalty for failure to file a report or a failure to furnish all of the required information in a report is $50 per report.[399]

## Description of Proposal

The proposal imposes a new assessable penalty for failure to file a report or to furnish information required in a report required by the ExSTARS system. The penalty is $10,000 per failure with respect to each vessel or facility (e.g., a terminal or other facility) for which information is required to be furnished. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

## Effective Date

The proposal is effective for penalties imposed after September 30, 2004.

**8. Collection from Customs bond where importer not registered**

## Present Law

Typically, gasoline, diesel fuel, and kerosene are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities that geographically are located closer to destination retail markets. A fuel is taxed when it "breaks bulk," *i.e.*, when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the "position holder," i.e., the person shown on the records of the terminal facility as owning the fuel.

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[397] Sec. 4010(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

[398] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

[399] Sec. 6721(a).

Tax is also imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing.[400] This tax does not apply to any entry of a taxable fuel transferred in bulk to a terminal or refinery if the person entering the taxable fuel and the operator of such terminal or refinery are registered. The "enterer" is liable for the tax. An enterer generally means the importer of record (under customs law) with respect to the taxable fuel. However, if the importer of record is acting as an agent (a broker for example), the person for whom the agent is acting is the enterer. If there is no importer of record for taxable fuel entered into the United States, the owner of the taxable fuel at the time it is brought into the United States is the enterer. An importer's liability for Customs duties includes a liability for any internal revenue taxes that attach upon the importation of merchandise unless otherwise provided by law or regulation.[401]

As a part of the entry documentation, the importer, consignee, or an authorized agent usually is required to file a bond with Customs. The bond, among other things, guarantees that proper entry summary, with payment of estimated duties and taxes when due, will be made for imported merchandise and that any additional duties and taxes subsequently found to be due will be paid.

As a condition of permitting anyone to be registered with the IRS, under section 4101 of the Code, the Secretary may require that such person give a bond in such sum as the Secretary determines appropriate.

## Description of Proposal

Under the proposal, the importer of record is jointly and severally liable for the tax imposed upon entry of fuel into the United States if, under regulations, any other person that is not registered with the Secretary as a taxable fuel registrant is liable for such tax. If the importer of record is liable for the tax and such tax is not paid on or before the last date prescribed for payment, the Secretary may collect such tax from the Customs bond posted with respect to the importation of the taxable fuel to which the tax relates.

For purposes of determining the jurisdiction of any court of the United States or any agency of the United States, any action by the Secretary to collect the tax from the Customs bond is treated as an action to collect tax from a bond authorized by section 4101 of the Code, not as an action to collect from a bond relating to the importation of merchandise.

## Effective Date

The proposal is effective for fuel entered after September 30, 2004.

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[400] Sec. 4081(a)(1)(A)(iii).

[401] 19 CFR 141.3.

### 9. Modification of the use tax on heavy highway vehicles

#### Present Law

An annual use tax is imposed on heavy highway vehicles, at the rates below.[402]

| | |
|---|---|
| Under 55,000 pounds | No tax |
| 55,000-75,000 pounds | $100 plus $22 per 1,000 pounds over 55,000 |
| Over 75,000 pounds | $550 |

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers are allowed to pay the tax in installments.[403] State governments are required to receive proof of payment of the use tax as a condition of vehicle registration.

Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[404] Any highway motor vehicle that is issued a base plate by Canada or Mexico and is operated on U.S. highways is subject to the highway use tax whether or not the vehicles are required to be registered in the United States. The tax rate for Canadian and Mexican vehicles is 75 percent of the rate that would otherwise be imposed.[405]

#### Description of Proposal

The proposal eliminates the ability to pay the tax in installments. It also eliminates the reduced rates for Canadian and Mexican vehicles. The proposal requires taxpayers with 25 or more vehicles for any taxable period to file their returns electronically. Finally, the proposal permits proration of tax for vehicles sold during the taxable period.

#### Effective Date

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

[402] Sec. 4481.

[403] Sec. 6156.

[404] See generally, sec. 4483.

[405] Sec. 4483(f): Treas. Reg. sec. 41.4483-7(a).

**10. Modification of ultimate vendor refund claims with respect to farming**

**Present Law**

In general, the Code provides that, if diesel fuel, kerosene, or aviation fuel on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) the amount of tax imposed. The refund is made to the ultimate purchaser of the taxed fuel. However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, refund payments are paid to the ultimate, registered vendors ("ultimate vendors") of such fuels.

**Description of Proposal**

In the case of diesel fuel or kerosene used on a farm for farming purposes, the proposal limits ultimate vendor claims for refund to sales of such fuel in amounts less than 250 gallons per farmer per claim.

**Effective Date**

The proposal is effective for fuels sold for nontaxable use after the date of enactment.

**11. Dedication of revenue from certain penalties to the Highway Trust Fund**

**Present Law**

Present law does not dedicate to the Highway Trust Fund any penalties assessed and collected by the Secretary.

**Description of Proposal**

The proposal dedicates to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715 (relating to dyed fuel sold for use or used in taxable use), 6715A (penalty for tampering or failing to maintain security requirements for mechanical dye injection systems), 6717 (penalty for failing to display tax registration on vessels), 6718 (penalty for failing to register under section 4101), 6725 (penalty for failing to report information required by the Secretary), 7232 (penalty for failing to register and false representations of registration status), and 7272 (but only with regard to penalties related to failure to register under section 4101).

**Effective Date**

The proposal is effective October 1, 2004.

**12. Taxable fuel refunds for certain ultimate vendors**

**Present Law**

The Code provides that, in the case of gasoline on which tax has been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, a wholesale distributor that sells the gasoline for such exempt purposes is treated as the person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid. In the case of undyed diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, a credit or payment is allowable only to the ultimate, registered vendors ("ultimate vendors") of such fuels.

In general, refunds are paid without interest. However, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, the Secretary is required to pay interest on certain refunds. The Secretary must pay interest on refunds of $200 or more ($100 or more in the case of kerosene) due to the taxpayer arising from sales over any period of a week or more, if the Secretary does not make payment of the refund within 20 days.

## Description of Proposal

For sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, the proposal conforms the payment of refunds to that procedure established under present law in the case of diesel fuel or kerosene. That is, the ultimate vendor claims for refund.

The proposal modifies the payment of interest on refunds. Under the proposal, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, all refunds unpaid after 45 days must be paid with interest. If the taxpayer has filed for his or her refund by electronic means, refunds unpaid after 20 days must be paid with interest.

Lastly, for claims for refund of tax paid on diesel fuel or kerosene sold to State and local governments or for sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed and for which the ultimate purchaser utilized a credit card, the proposal deems the person extending the credit to the ultimate purchaser to be the ultimate vendor. That is, the person extending credit via a credit card administers claims for refund, and is responsible for supplying all the appropriate documentation currently required from ultimate vendors.

## Effective Date

The proposal is effective on October 1, 2004.

### 13. Two-party exchanges

**Present Law**

Most fuel is taxed when it is removed from a registered terminal.[406] The party liable for payment of this tax is the "position holder." The position holder is the person reflected on the records of the terminal operator as holding the inventory position in the fuel.[407]

It is common industry practice for oil companies to serve customers of other oil companies under exchange agreements, *e.g.*, where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) owns the fuel when the motor fuel is removed from the terminal and sold to B's customer.

**Description of Proposal**

The proposal permits two registered parties to switch position holder status in fuel within a registered terminal (thereby relieving the person originally owning the fuel[408] of tax liability as the position holder) if all of the following occur:

(1) The transaction includes a transfer from the original owner, i.e., the person who holds the original inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator prior to the transaction.

(2) The exchange transaction occurs at the same time as completion of removal across the rack from the terminal by the receiving person or its customer.

(3) The terminal operator in its books and records treats the receiving person as the person that removes the product across a terminal rack for purposes of reporting the transaction to the Internal Revenue Service.

(4) The transaction is the subject of a written contract.

**Effective Date**

The proposal is effective on the date of enactment.

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[406] A "terminal" is a storage and distribution facility that is supplied by pipeline or vessel, and from which fuel may be removed at a rack. A "rack" is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel.

[407] Such person has a contractual agreement with the terminal operator to store and provide services with respect to the fuel. A "terminal operator" is any person who owns, operates, or otherwise controls a terminal. A terminal operator can also be a position holder if that person owns fuel in its terminal.

[408] In the proposal, this person is referred to as the "delivering person."

**14. Simplification of tax on tires**

## Present Law

A graduated excise tax is imposed on the sale by a manufacturer (or importer) of tires designed for use on highway vehicles (sec. 4071). The tire tax rates are as follows:

| Tire Weight | Tax Rate |
|---|---|
| Not more than 40 lbs. | No tax |
| More than 40 lbs., but not more than 70 lbs. | 15 cents/lb. in excess of 40 lbs. |
| More than 70 lbs., but not more than 90 lbs. | $4.50 plus 30 cents/lb. in excess of 70 lbs. |
| More than 90 lbs. | $11.50 plus 50 cents/lb. in excess of 90 lbs. |

No tax is imposed on the recapping of a tire that previously has been subject to tax. Tires of extruded tiring with internal wire fastening also are exempt.

The tax expires after September 30, 2005.

## Description of Proposal

The proposal modifies the excise tax applicable to tires. The proposal replaces the present-law tax rates based on the weight of the tire with a tax rate based on the load capacity of the tire. In general, the tax is 9.4 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. In the case of a biasply tire, the tax rate is 4.7 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds.

The proposal modifies the definition of tires for use on highway vehicles to include any tire marked for highway use pursuant to certain regulations promulgated by the Secretary of Transportation. The proposal also exempts from tax any tire sold for the exclusive use of the United States Department of Defense or the United States Coast Guard.

Tire load capacity is the maximum load rating labeled on the tire pursuant to regulations promulgated by the Secretary of Transportation. A biasply tire is any tire manufactured primarily for use on piggyback trailers.

## Effective Date

The proposal is effective for sales in calendar years beginning more than 30 days after the date of enactment.

## D. Nonqualified Deferred Compensation Plans

### 1. Treatment of nonqualified deferred compensation plans

**Present Law**

**In general**

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[409] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[410] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment

[409] *See, e.g.*, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[410] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[411] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

**Rabbi trusts**

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[412] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.[413] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

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[411] Treas. Reg. secs. 1.451-1 and 1.451-2.

[412] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[413] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which attempt to allow deferred amounts to be available to individuals, while still purporting to meet the safe harbor requirements set forth by the IRS.

## **Description of Proposal**

Under the proposal, all amounts deferred under a nonqualified deferred compensation plan[414] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[415] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the proposal are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the proposal.

Under the proposal, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees[416] of publicly-traded corporations.

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

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[414] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

[415] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[416] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the proposal. The proposal requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

A participant is considered disabled if he or she (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason on any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The proposal provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

The proposal requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the proposal.

Under the proposal, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary shall issue guidance, consistent with the purposes of the proposal, regarding to what extent elections to change a stream of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the proposal, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets are located outside of the United States or at the time transferred if such assets are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The Secretary has authority to exempt arrangements from the proposal if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the proposal, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[417] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the proposal.[418] Plans subject to section 457, other than governmental eligible deferred compensation plans, are subject to both the requirements of section 457 and the proposal. For example, in addition to the requirements of the proposal, an eligible deferred compensation plan of a tax-exempt employer would still be required to meet the applicable dollar limits under section 457.

Interest imposed under the proposal is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the proposal. The proposal is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the proposal. Any amount included in gross income under the proposal shall not be required to be included in gross income under any provision of law later than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the proposal, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable

[417] A qualified employer plan also includes a section 501(c)(18) trust.

[418] A governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[419]

The proposal provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of proposal, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the proposals providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used inconsistent with the purposes of the proposal. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

## Effective Date

The proposal is effective for amounts deferred after June 3, 2004. The proposal does not apply to amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004. Earnings on amounts deferred before the effective date are subject to the proposal to the extent that such amounts deferred are subject to the proposal.

It is intended that amounts further deferred under a subsequent election with respect to amounts originally deferred before June 4, 2004, are subject to the requirements of the proposal.

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted before June 4, 2004, may, without violating the requirements of the proposal, terminate participation or cancel an outstanding deferral election with regard to amounts earned after June 3, 2004, if such amounts are includible in income as earned.

[419] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

## E. Other Revenue Provisions

### 1. Qualified tax collection contracts

**Present Law**

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only Federal government employees were permitted to collect the taxes.[420] The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[421] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot. The pilot program results were disappointing because "IRS' efforts to design and implement the private debt collection pilot program were hindered by limitations that affected the program's results." The limitations included the scope of work permitted to the private debt collection companies, the number and type of cases referred to the private debt collection companies, and the ability of IRS' computer systems to identify, select, and transmit collection cases to the private debt collectors.

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[422]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[423] That provision does not apply to the collection of debts under the Internal Revenue Code.[424]

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[420] Sec. 7801(a).

[421] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

[422] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.

[423] 31 U.S.C. sec. 3718.

[424] 31 U.S.C. sec. 3718(f).

The President's fiscal year 2004 and 2005 budget proposals proposed the use of private debt collection companies to collect Federal tax debts.

**Description of Proposal**

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type[425] and to arrange payment of those taxes by the taxpayers. There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability. An assessment is the formal recording of the taxpayer's tax liability that fixes the amount payable. An assessment must be made before the IRS is permitted to commence enforcement actions to collect the amount payable. In general, an assessment is made at the conclusion of all examination and appeals processes within the IRS.[426]

Several steps are involved in the deployment of private debt collection companies. First, the private debt collection company contacts the taxpayer by letter.[427] If the taxpayer's last known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[428] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as five years. If the taxpayer is unable to pay the outstanding tax liability in full over a five-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The proposal specifies several procedural safeguards and conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the

[425] The proposal generally applies to any type of tax imposed under the Internal Revenue Code. It is anticipated that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[426] An amount of tax reported as due on the taxpayer's tax return is considered to be self-assessed. If the IRS determines that the assessment or collection of tax will be jeopardized by delay, it has the authority to assess the amount immediately (sec. 6861), subject to several procedural safeguards.

[427] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to section 6103 is necessary to implement the provision. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

[428] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees are also made statutorily applicable to employees of private sector debt collection companies. Third, the private sector debt collection companies are required to inform taxpayers of the availability of assistance from the Taxpayer Advocate. Fourth, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS.

The proposal creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The proposal prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[429]

**<u>Effective Date</u>**

The proposal is effective on the date of enactment.

### 2. Modify charitable contribution rules for donations of patents and other intellectual property

**<u>Present Law</u>**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[430] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

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[429] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.

[430] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

Under present law, certain copyrights are not considered capital assets, in which case the charitable deduction for such copyrights generally is limited to the taxpayer's basis.[431]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[432] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[433] In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[434]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[435] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[436] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of

[431] *See* sec. 1221(a)(3), 1231(b)(1)(C).

[432] Sec. 170(f)(3).

[433] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

[434] Sec. 170(f)(8).

[435] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[436] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[437]

## Description of Proposal

The proposal provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property. For this purpose, "qualified donee income" includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income received or accrued by the charitable donee that properly is allocable to the contributed property to the applicable taxable year of the donor, determined as follows:

| **Taxable Year of Donor** | **Deduction Permitted for Such Taxable Year** |
|---|---|
| 1st year ending on or after contribution | 100 percent of qualified donee income |
| 2nd year ending on or after contribution | 100 percent of qualified donee income |
| 3rd year ending on or after contribution | 90 percent of qualified donee income |
| 4th year ending on or after contribution | 80 percent of qualified donee income |
| 5th year ending on or after contribution | 70 percent of qualified donee income |
| 6th year ending on or after contribution | 60 percent of qualified donee income |
| 7th year ending on or after contribution | 50 percent of qualified donee income |
| 8th year ending on or after contribution | 40 percent of qualified donee income |
| 9th year ending on or after contribution | 30 percent of qualified donee income |
| 10th year ending on or after contribution | 20 percent of qualified donee income |
| 11th year ending on or after contribution | 10 percent of qualified donee income |
| 12th year ending on or after contribution | 10 percent of qualified donee income |
| Taxable years thereafter | No deduction permitted |

[437] Treas. Reg. sec. 1.170A-13(c)(3).

An additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated pursuant to the sliding-scale exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property.

No charitable deduction is permitted with respect to any revenues or income received or accrued by the charitable donee after the expiration of the legal life of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer is required to inform the donee at the time of the contribution that the taxpayer intends to treat the contribution as a contribution subject to the additional charitable deduction provisions of the proposal. In addition, the taxpayer must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the charity's taxable year.[438] The donee is required to file an annual information return that reports the qualified donee income and other specified information relating to the contribution. In instances where the donor's taxable year differs from the donee's taxable year, the donor bases its additional charitable deduction on the qualified donee income of the charitable donee properly allocable to the donee's taxable year that ends within the donor's taxable year.

Under the proposal, additional charitable deductions are not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation or certain other private foundations described in section 170(b)(1)(E)).

Under the proposal, the Secretary may prescribe regulations or other guidance to carry out the purposes of the proposal, including providing for the determination of amounts to be treated as qualified donee income in certain cases where the donee uses the donated property to further its exempt activities or functions, or as may be necessary or appropriate to prevent the avoidance of the purposes of the proposal.

## Effective Date

The proposal is effective for contributions made after June 3, 2004.

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[438] The net income taken into account by the taxpayer may not exceed the amount of qualified donee income reported by the donee to the taxpayer and the IRS under the proposal's substantiation and reporting requirements.

### 3. Require increased reporting for noncash charitable contributions

**Present Law**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[439] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Taxpayers are required to obtain a qualified appraisal for donated property (other than money and publicly traded securities) with a value of more than $5,000.[440] Corporations (other than a closely-held corporation, a personal service corporation, or an S corporation) are not required to obtain a qualified appraisal. Taxpayers are not required to attach a qualified appraisal to the taxpayer's return, except in the case of contributed art-work valued at more than $20,000. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[441] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of

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[439] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[440] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under P.L. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and taxpayer identification number of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[441] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[442]

## Description of Proposal

The proposal requires increased donor reporting for certain charitable contributions of property other than cash, inventory, or publicly traded securities. The proposal extends to all C corporations the present law requirement, applicable to an individual, closely-held corporation, personal service corporation, partnership, or S corporation, that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. The proposal also provides that if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor's tax return. For purposes of the dollar thresholds under the proposal, property and all similar items of property donated to one or more donees are treated as one property.

The proposal provides that a donor that fails to substantiate a charitable contribution of property, as required by the Secretary, is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. The denial of the deduction does not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

The proposal provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations that may provide that some or all of the requirements of the proposal do not apply in appropriate cases.

## Effective Date

The proposal is effective for contributions made after June 3, 2004.

### 4. Require qualified appraisals for charitable contributions of vehicles

## Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[443] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to determine the deductible amount by subtracting any gain from fair market value, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of

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[442] Treas. Reg. sec. 1.170A-13(c)(3).

[443] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

A taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer's basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as boats.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[444] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[445] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair

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[444] Pub. L. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[445] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[446]

Appraisal fees paid by an individual to determine the fair market value of donated property are deductible as miscellaneous expenses subject to the 2 percent of adjusted gross income limit.[447]

### Description of Proposal

The proposal allows a charitable deduction for contributions of vehicles for which the taxpayer claims a deduction of more than $250 only if the taxpayer obtains a qualified appraisal of the vehicle. The proposal applies to automobiles and other types of motor vehicles manufactured primarily for use on public streets, roads, and highways; boats; and aircraft. The proposal does not affect contributions of inventory property. The definition of qualified appraisal generally follows the definition contained in present law, subject to additional regulations or guidance provided by the Secretary. The qualified appraisal of a donated vehicle must be obtained by the taxpayer by the time the contribution is made. Under the proposal, the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of the proposal.

### Effective Date

The proposal is effective for contributions made after June 3, 2004.

## 5. Extend the present-law intangible amortization provisions to acquisitions of sports franchises

### Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[448] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[449] However, other special rules apply to certain of these intangible assets.

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[446] Treas. Reg. sec. 1.170A-13(c)(3).

[447] Rev. Rul. 67-461, 1967-2 C.B. 125.

[448] Sec. 197.

[449] Sec. 197(e)(6).

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[450] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

In general, section 1245 provides that gain from the sale of certain property is treated as ordinary income to the extent depreciation or amortization was allowed on such property. Section 1245(a)(4) provides special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply in the case of the sale, exchange, or other disposition of a sports franchise. Under the special recapture rules, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise.

## Description of Proposal

The proposal extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with the acquisition of such a franchise (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises. The proposal also repeals the special rules under section 1245(a)(4) and makes other conforming changes.

## Effective Date

The proposal is effective for property acquired after the date of enactment. The amendment to section 1245(a)(4) applies to franchises acquired after the date of enactment.

### 6. Increase continuous levy for certain Federal payments

## Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[451] by the IRS, the IRS may then collect the tax by levy upon all property and

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[450] *P.D.B. Sports, Ltd. v. Comm.*, 109 T.C. 423 (1997).

[451] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be

rights to property belonging to the person,[452] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[453]

A continuous levy is applicable to specified Federal payments.[454] This includes any Federal payment for which eligibility is not based on the income and/or assets of a payee. Thus, a Federal payment to a vendor of goods or services to the Federal government is subject to continuous levy. This continuous levy attaches up to 15 percent of any specified payment due the taxpayer.

**Description of Proposal**

The proposal permits a levy of up to 100 percent of a Federal payment to a vendor of goods or services to the Federal government.

**Effective Date**

The proposal is effective on the date of enactment.

### 7. Modification of straddle rules

**Present Law**

**In general**

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[455] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

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mailed to the person's last known address or left at the person's dwelling or usual place of business (sec. 6303).

[452] Sec. 6331.

[453] Secs. 6335-6343.

[454] Sec. 6331(h).

[455] Sec. 1092.

**Positions in stock**

The straddle rules also generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock,[456] (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

The stock exception from the straddle rules has been curtailed severely by legislative amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[457]

**Unbalanced straddles**

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[458] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting the loss leg of the straddle.

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[456] Although the straddles rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules do not apply if the option is a "qualified covered call option" written by the taxpayer. In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

[457] Prop. Treas. Reg. sec. 1.1092(d)-2(c).

[458] Sec. 1092(c)(2)(B).

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[459] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[460] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock--i.e., the number of shares specified in the costless collar--because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) and (3) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

## Description of Proposal

The proposal modifies the straddle rules in three respects: (1) permits taxpayers to identify offsetting positions of a straddle; (2) provides a special rule to clarify the present-law treatment of certain physically settled positions of a straddle; and (3) repeals the stock exception from the straddle rules.

Under the proposal, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle.[461] If there is a loss with respect to any identified position that is part of an identified straddle, the general straddle loss deferral rules do not apply to such loss. Instead, the basis of each of the identified positions that offset the loss position in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain (if any) with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all positions that offset the loss position in the identified

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[459] Priv. Ltr. Rul. 199925044 (Feb. 3, 1999).

[460] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

[461] However, to the extent provided by Treasury regulations, taxpayers are not permitted to identify offsetting positions of a straddle if the fair market value of the straddle position already held by the taxpayer at the creation of the straddle is less than its adjusted basis in the hands of the taxpayer.

straddle.[462] Any loss with respect to an identified position that is part of an identified straddle cannot otherwise be taken into account by the taxpayer or any other person to the extent that the loss increases the basis of any identified positions that offset the loss position in the identified straddle.

In addition, the proposal provides authority to issue Treasury regulations that would specify: (1) the proper methods for clearly identifying a straddle as an identified straddle (and identifying positions as positions in an identified straddle); (2) the application of the identified straddle rules for a taxpayer that fails to properly identify the positions of an identified straddle;[463] and (3) provide an ordering rule for dispositions of less than an entire position that is part of an identified straddle.

The proposal also clarifies the present-law straddle rules with respect to taxpayers that settle a position that is part of a straddle by delivering property to which the position relates. Specifically, the proposal clarifies that the present-law straddle loss deferral rules treat as a two-step transaction the physical settlement of a straddle position that, if terminated, would result in the realization of a loss. With respect to the physical settlement of such a position, the taxpayer is treated as having terminated the position for its fair market value immediately before the settlement. The taxpayer then is treated as having sold at fair market value the property used to physically settle the position.

The proposal also eliminates the exception from the straddle rules for stock (except qualified covered call options). Thus, offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle if holding one of the positions results in a substantial diminution of the taxpayer's risk of loss with respect to holding the other position.

**Effective Date**

The proposal is effective for positions established on or after the date of enactment.

[462] For this purpose, "unrecognized gain" is the excess of the fair market value of an identified position that is part of an identified straddle at the time the taxpayer incurs a loss with respect to another identified position in the identified straddle, over the fair market value of such position when the taxpayer identified the position as a position in the identified straddle.

[463] For example, although the proposal does not require taxpayers to identify any positions of a straddle as an identified straddle, it may be necessary to provide rules requiring all balanced offsetting positions to be included in an identified straddle if a taxpayer elects to identify any of the offsetting positions as an identified straddle.

**8. Add vaccines against Hepatitis A to the list of taxable vaccines**

## Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[464] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

## Description of Proposal

The bill adds any vaccine against hepatitis A to the list of taxable vaccines.

## Effective Date

The proposal is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

**9. Add vaccines against influenza to the list of taxable vaccines**

## Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[465] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of

[464] Sec. 4131

[465] Sec. 4131

the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

## Description of Proposal

The bill adds any trivalent vaccine against influenza to the list of taxable vaccines.

## Effective Date

The proposal is effective for vaccines sold or used beginning on the later of the first day of the first month beginning more than four weeks after the date of enactment or the date on which the Secretary of Health and Human Services lists any such vaccine for purpose of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

### 10. 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.[466] Public Law 108-89[467] extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.[468]

## Description of Proposal

The proposal extends the statutory authorization for these user fees through September 30, 2014.

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[466] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100-203, December 22, 1987). Pub. L. No. 104-117 (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)) extended the statutory authorization for these user fees through September 30, 2003.

[467] 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

[468] That Public Law also moved 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. No. 107-16, June 7, 2001).

### Effective Date

The proposal is effective for requests made after the date of enactment.

**11. Extension of customs user fees**

### Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (Pub. L. No. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (Pub. L. No. 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 108-121 which extended authorization for the collection of these fees through March 1, 2005.[469]

### Description of Proposal

The proposal extends the passenger and conveyance processing fees and the merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2014. For fiscal years after September 30, 2005, the Secretary is to charge fees in amount that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The proposal also includes a Sense of the Congress that the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The Sense of Congress also states that the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

The proposal further provides that the Secretary conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on what fees should be eliminated, what the rate of fees retains should be, and any other recommendations with respect to the fees that the Secretary considers appropriate.

### Effective Date

The proposal is effective upon the date of enactment.

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[469] Sec. 201; 117 Stat. 1335.

### 12. Safe harbor for churches

**Present Law**

Organizations described in section 501(c)(3) and exempt from tax under section 501(a), including churches, their integrated auxiliaries, and conventions or associations of churches, may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[470] The prohibition on such political activity is absolute. The sanction for a violation of the prohibition is loss of the organization's tax exempt status and the ability to receive tax deductible contributions.

There are three elements to the prohibition: there must be a "candidate," for "public office," and "participation" or "intervention" in a political campaign. Treasury regulations define a candidate as "an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local."[471] The definition includes persons who have declared an intention to run for office and generally would include incumbents until such time as an incumbent declared an intention not to run for reelection. Treasury regulations do not define "public office"; however, the definition of candidate refers to an "elective public office, whether . . . national, State, or local." The IRS has interpreted "public office" to include elective positions in political parties.

Section 501(c)(3) states that participation in a political campaign includes "the publishing or distribution of statements." Treasury regulations also provide that "publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to . . . a candidate" is intervention in a political campaign, and that intervention is not limited to such activities.[472]

In general, political activities that are educational are permitted. Educational activities are those that present "a sufficiently full and fair exposition of the pertinent facts," are not biased, and "permit an individual or the public to form an independent opinion or conclusion."[473] Publicly supported charities also generally may provide a forum for debates by candidates, so long as the forum is fair and neutral and all qualified candidates are given equal time for debate.[474] Voter registration by public charities generally is permitted so long as the activity is conducted in a nonpartisan and fair manner. Other forms of voter education, such as publication of voter guides, also may be permissible if certain guidelines are followed.[475] The prohibition on

[470] Sec. 501(c)(3).

[471] Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii).

[472] *Id.*

[473] Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

[474] *See* Rev. Rul. 86-95, 1986-2 C.B. 73.

[475] Rev. Rul. 78-248, 1978-1 C.B. 154.

political activity is not intended to restrict free expression on political matters by persons speaking for themselves as individuals and not as representatives of a charitable organization. Individuals who speak on their own behalf under facts and circumstances that clearly show that the speech is not attributable to the individual's organization do not implicate the tax-exempt status of such organization.

For organizations that engage in prohibited political activity, three penalties may be applied either as alternatives to revocation of tax exemption or in addition to loss of tax-exempt status: an excise tax,[476] termination assessment of all taxes due,[477] and an injunction against further political expenditures.[478]

## Description of Proposal

The proposal provides for special rules with respect to the political activities of churches, their integrated auxiliaries, and conventions or associations of churches (collectively referred to as "church" or "churches"). Under the proposal, a statement by a religious leader of a church that is clearly identified as a statement made as a private citizen and not made on behalf of or in representation of such church does not jeopardize the church's tax exempt status, affect the church's status as an organization to which contributions are deductible, or provide a basis for the application of excise taxes to the church or church management for prohibited political expenditures. A statement is not treated as clearly identified as made as a private citizen if a statement is made in an official publication of such church, at an official function of such church, or if a statement is paid for in whole or part by such church.

In addition, as an alternative to revocation of a church's tax exemption and loss of status as an organization to which deductible contributions may be made, the proposal provides for intermediate sanctions for unintentional violations by a church (including unintentional violations by religious leaders of a church not acting in their private capacity) of the prohibition on political activity. Such intermediate sanctions apply for up to three unintentional violations by a church during any calendar year. The present law penalty of revocation of exemption continues to apply to any violation that constitutes an intentional disregard by such church of the political activity prohibition and to more than three unintentional violations in a calendar year. It is intended that a violation is not considered unintentional merely because the person committing the violation did not know that political activity by a church is prohibited or that the activity conducted constituted a violation.

Under the intermediate sanctions regime of the proposal, for a single unintentional violation during a calendar year, tax is imposed at the highest corporate tax rate on 1/52 of the church's gross income for such year; for two unintentional violations during a calendar year, tax is imposed at the highest corporate tax rate on one half of the church's gross income for such year; and for three unintentional violations during a calendar year, tax is imposed at the highest

[476] Sec. 4955.

[477] Sec. 6852(a)(1).

[478] Sec. 7409.

corporate tax rate on all of the church's gross income for such year. The amount of tax imposed with respect to an act is reduced by the amount of any tax imposed with respect to such act as a political expenditure pursuant to section 4955. Churches subject to intermediate sanctions under the proposal are required to file a return in a time and manner to be provided by the Secretary. Such return is subject to the generally applicable accuracy and fraud-related penalties imposed by the Code.

**Effective Date**

The proposal is effective for acts occurring after the date of enactment.

## VII. MARKET REFORM FOR TOBACCO GROWERS

### Present Law

The current tobacco program has two main components: a supply management component and a price support component. In addition, in 1982, Congress passed the "No-Net-Cost Tobacco Program Act"[479] that assured the tobacco program would run at no-net cost to the Federal government.

#### Supply management

The supply management component limits and stabilizes the quantity of tobacco marketed by farmers. This is achieved through marketing quotas. The Secretary of Agriculture raises or lowers the national marketing quota on an annual basis. The Secretary establishes the national marketing quota for each type of tobacco based upon domestic and export demand, but at a price above the government support price. The purpose of matching supply with demand is to keep the price of tobacco high. There is a secondary market in tobacco quota. Tobacco growers who do not have sufficient quota may purchase or rent one.

#### Support price

Given the numerous variables that affect tobacco supply and demand, marketing quotas alone have not always been able to guarantee tobacco prices. Therefore, in addition to marketing quotas, Federal support prices are established and guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the Department of Agriculture using the formula specified in the law to calculate loan levels. This system guarantees minimum prices for the different types of tobacco.

The national loan price on 2004 crop flue-cured tobacco is $1.69 per pound; the burley loan price is $1.873 per pound.

#### No-net-cost assessment

In 1982, Congress passed the "No-Net-Cost Tobacco Program Act." The purpose of this program is to ensure that the nonrecourse loan program is run at no-net-cost to the Federal government.

When tobacco is not contracted, it is sold at an auction sale barn. At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. When the bid does not exceed this price, the farmer may choose to be paid the loan price by a cooperative, with money borrowed from the Commodity Credit Corporation ("CCC"). In such cases, the tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for the

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[479] Pub. L. No. 97-218 (1982).

CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest. If the cooperative does not recover the cost of the loan plus interest, the Secretary of Agriculture assesses growers, purchasers and importers of tobacco in order to repay the difference. All growers, purchasers and importers of tobacco participate in paying these assessments, regardless of whether or not they participate in the loan program.

The no-net-cost assessment on 2004 crop flue-cured is 10 cents per pound; the burley assessment is 2 cents per pound. The no-net-cost assessment funds are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations.

Currently, over 80 percent of growers market their tobacco through contracts with tobacco companies, and thus these growers do not participate in the loan program. However, they must still pay the no-net-cost assessment when the Secretary levies it. The remaining 20 percent of growers market their tobacco through the auction system, and are eligible for participation in the loan program. Of this group, over 60 percent have consistently participated in the loan program during the past several years.

## Description of Proposal

The proposal repeals the Federal tobacco support program, including marketing quotas and nonrecourse marketing loans.[480]

The proposal also provides quota holders $7.00 per pound on their 2002 quota allotment paid in equal installments over five years.[481]

Additionally, the proposal provides producers transition payments of $3.00 per pound based on their 2002 quota levels paid in equal installments over five years.[482]

The proposal caps payments to quota holders and growers at $9.6 billion over fiscal years 2005 through 2009.[483]

## Effective Date

The proposal is effective on the date of enactment.

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[480] Secs. 711-712.

[481] Sec. 722.

[482] Sec. 723.

[483] Sec. 725.