

**DESCRIPTION OF
THE “ENERGY TAX INCENTIVES ACT OF 2003”**

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on April 2, 2003, on the “Energy Tax Incentives Act of 2003.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the “Energy Tax Incentives Act of 2003.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the “Energy Tax Incentives Act of 2003”* (JCX-21-03), March 31, 2003.

I. RENEWABLE ENERGY

A. 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 was 1.8 cents per kilowatt hour for 2002. 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, closed-loop biomass facilities, and poultry waste facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities and December 31, 1999 in the case of poultry waste facilities) and before January 1, 2007.

The proposal provides that, for facilities placed in service after the date of enactment, the amount of the credit will be 1.5 cents per kilowatt hour with no adjustment for inflation for production in years after 2003.

The proposal also defines six new qualifying energy resources: biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, municipal biosolids, and recycled sludge.

Qualifying biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2005. Qualifying agricultural livestock waste nutrient facilities are facilities using agricultural livestock waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007.

For a facility placed in service after the date of enactment, the ten-year credit period commences when the facility is placed in service. In the case of biomass facility originally placed in service before the date of enactment, the ten-year credit period is reduced to a five-year period and commences after December 31, 2003 and the otherwise allowable 1.5 cent-per-kilowatt-hour credit is reduced to a 1.0 cent-per-kilowatt-hour credit.

The proposal modifies present law to provide that qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992 and modified to use closed-loop biomass to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, before January 1, 2007. The taxpayer may claim credit for electricity produced at such qualifying facilities with the credit amount equal to the otherwise allowable credit multiplied by the ratio of the thermal content of the closed loop biomass fuel burned in the facility to the thermal content of all fuels burned in the facility.

Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. In the case of qualifying geothermal energy facilities and qualifying solar energy facilities, taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility is placed in service.

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is less than five megawatts.

A qualified municipal biosolids facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A qualifying recycled sludge facility is a facility originally placed in service after the date of enactment and before January 1, 2007.

Biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill and harvesting residues, precommercial thinnings, slash, and brush. Solid wood waste materials

include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying biomass for purposes of this proposal does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. Agricultural waste nutrients are defined as livestock manure and litter, including bedding material for the disposition of manure. Agricultural livestock comprise bovine, swine, poultry,² and sheep among others.

Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).

Municipal biosolids are the residue or solids removed by a municipal wastewater treatment facility.

Recycled sludge is the recycled residue byproduct created in the treatment of commercial, industrial, municipal, or navigational wastewater, but not including residues from incineration.

The proposal provides that certain persons (public utilities, electric cooperatives, rural electric cooperatives, and Indian tribes) may sell, trade, or assign to any taxpayer any credits that would otherwise be allowable to that person, if that person were a taxpayer, for production of electricity from a qualified facility owned by such person. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent transfers are not permitted. In addition, any credits that would otherwise be allowable to such person, to the extent provided by the Administrator of the Rural Electrification Administration, may be applied as a prepayment to certain loans or obligations undertaken by such person under the Rural Electrification Act of 1936.

In the case of qualifying open-loop biomass facilities and qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, the provision permits a lessee or operator to claim the credit in lieu of the owner of the facilities.

Lastly, the proposal repeals the present-law reduction in allowable credit for facilities financed with tax-exempt bonds or with certain loans received under the Rural Electrification Act of 1936. In the case of qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, the proposal repeals the present-law reduction in allowable credit for facilities that receive any subsidy.

² The proposal deletes poultry litter as a separate qualifying facility for facilities placed in service after the effective date.

Effective Date

The proposal generally is effective for electricity sold from qualifying facilities after the date of enactment. For electricity produced from qualifying open-loop biomass facilities originally placed in service prior to the date of enactment, the provision is effective January 1, 2004.

II. ALTERNATIVE VEHICLES AND FUEL INCENTIVES

A. Modifications and Extensions of Provisions Relating to Electric Vehicles, Clean-Fuel Vehicles, and Clean-Fuel Vehicle Refueling Property

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 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 capacities of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

Clean-fuel vehicle refueling property

Clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to \$100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. The deduction is unavailable for costs incurred after December 31, 2006.

Description of Proposal

Alternative motor vehicle credits

The proposal would provide a credit for the purchase of a new qualified fuel cell motor vehicle, a new qualified hybrid motor vehicle, and a new qualified alternative fuel motor vehicle.

In general the proposal provides that the buyer claims the credit, unless the buyer is a tax-exempt entity in which case the seller or lessor of the vehicle may claim the credit. The taxpayer may carry forward unused credits for 20 years or carry unused credits back for three years (but not to any taxable year beginning before the date of enactment). Qualified vehicles are vehicles placed in service before 2007 (2012 in the case of fuel cell vehicles). Any deduction otherwise allowable under sec. 179A is reduced by the amount of credit allowable.

Fuel cell vehicles

A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes (see below). Table 1 below, shows the proposed base credit amounts.

Table 1.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
vehicle ≤ 8,500.....	\$3,400
8,500 < vehicle ≤ 14,000.....	\$8,500
14,000 < vehicle ≤ 26,000.....	\$17,000
26,000 < vehicle.....	\$34,000

Table 2, below, shows the proposed additional credits for passenger automobiles or light trucks.

Table 2.–Credit for Qualifying Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	at least	but less than
\$1,000	150% of base fuel economy	175% of base fuel economy
\$1,500	175% of base fuel economy	200% of base fuel economy
\$2,000	200% of base fuel economy	225% of base fuel economy
\$2,500	225% of base fuel economy	250% of base fuel economy
\$3,000	250% of base fuel economy	275% of base fuel economy
\$3,500	275% of base fuel economy	300% of base fuel economy
\$4,000	300% of base fuel economy	

Hybrid vehicles

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). The amount of credit for the purchase of a hybrid vehicle is the sum of two components. In the case of an automobile or light truck, the amount of credit is the sum of a base credit amount that varies with the amount of power available from the rechargeable storage system and a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard. In the case of a heavy duty hybrid motor vehicle (a vehicle weighing more than 10,000 pounds), the amount of credit is the sum of a base credit amount that varies, by vehicle weight class, with the amount of power available from the rechargeable storage system and an additional credit for early adoption of the technology that varies with the model year of the vehicle purchased.

For these purposes, a vehicle’s power available from its rechargeable energy storage system as a percentage of maximum available power is calculated as the maximum value available from the battery or other energy storage device during a standard power test, divided by the sum of the battery or other energy storage device and the SAE net power of the heat engine.

Table 3, below, shows the proposed base credit amounts for automobiles and light trucks.

**Table 3.—Hybrid Vehicle Base Credit Amount for Automobiles and Light Trucks,
Dependent Upon the Power Available from the Rechargeable Energy Storage
System as a Percentage of the Vehicles Maximum Available Power**

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
\$100	4% of maximum available power	10% of maximum available power
\$200	10% of maximum available power	20% of maximum available power
\$300	20% of maximum available power	30% of maximum available power
\$400	30% of maximum available power	

Table 4, below, shows the proposed additional fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes (see below).

Table 4.—Additional Fuel Economy Credit for Hybrid Vehicles

Credit	If Fuel Economy of the Hybrid Vehicle Is:	
	at least	but less than
\$500	125% of base fuel economy	150% of base fuel economy
\$1,000	150% of base fuel economy	175% of base fuel economy
\$1,500	175% of base fuel economy	200% of base fuel economy
\$2,000	200% of base fuel economy	225% of base fuel economy
\$2,500	225% of base fuel economy	250% of base fuel economy
\$3,000	250% of base fuel economy	

Table 5 below, shows the proposed base credit amounts for heavy duty hybrid vehicles weighing 14,000 pounds or less.

Table 5.–Hybrid Vehicle Base Credit Amount for Heavy Duty Vehicles Weighing Not More Than 14,000 pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
\$400	20% of maximum available power	30% of maximum available power
\$700	30% of maximum available power	40% of maximum available power
\$800	40% of maximum available power	50% of maximum available power
\$900	50% of maximum available power	60% of maximum available power
\$1,000	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing not more than 14,000 pounds, the additional credit amount for early adoption of the technology is \$3,000 for model year 2003 vehicles, \$2,500 for model year 2004 vehicles, \$2,000 for model year 2005 vehicles, and \$1,500 for model year 2006 vehicles.

Table 6, below, shows the proposed base credit amounts for heavy duty hybrid vehicles weighing more than 14,000 pounds but not more than 26,000 pounds.

Table 6.–Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 14,000 Pounds, But Not More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
\$1,600	20% of maximum available power	30% of maximum available power
\$1,800	30% of maximum available power	40% of maximum available power
\$2,000	40% of maximum available power	50% of maximum available power
\$2,200	50% of maximum available power	60% of maximum available power
\$2,400	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing more than 14,000 pounds but not more than 26,000 pounds, the additional credit amount for early adoption of the technology is \$7,750 for model year 2003 vehicles, \$6,500 for model year 2004 vehicles, \$5,250 for model year 2005 vehicles, and \$4,000 for model year 2006 vehicles.

Table 7, below, shows the proposed base credit amounts for heavy duty hybrid vehicles weighing more than 26,000 pounds.

Table 7.—Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
\$2,400	20% of maximum available power	30% of maximum available power
\$2,800	30% of maximum available power	40% of maximum available power
\$3,200	40% of maximum available power	50% of maximum available power
\$3,600	50% of maximum available power	60% of maximum available power
\$4,000	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing more than 26,000 pounds, the additional credit amount for early adoption of the technology is \$12,000 for model year 2003 vehicles, \$10,000 for model year 2004 vehicles, \$8,000 for model year 2005 vehicles, and \$6,000 for model year 2006 vehicles.

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle would be 40 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between \$4,000 and \$35,000 depending upon the weight of the vehicle. Table 8, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class.

Table 8.—Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating in Pounds	Maximum Allowable Incremental Cost
vehicle ≤ 8,500.....	\$4,000
8,500 < vehicle ≤ 14,000.....	\$8,500
14,000 < vehicle ≤ 26,000.....	\$20,000
26,000 < vehicle.....	\$35,000

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel (except in the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy for vehicles by inertia weight class by vehicle type. The “vehicle inertia weight class” is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 9, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 9.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Modification of credit for qualified electric vehicles

The proposal repeals the phaseout of the credit under present law. The proposal also modifies present law to provide for a credit equal to the lesser of \$1,275 or 10 percent of the manufacturer’s suggested retail price of certain vehicles that conform to the Motor Vehicle Safety Standard 500. For all other electric vehicles, Table 10, below describes the credit.

Table 10.–Credit for Qualifying Battery Electric Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500.....	\$2,975
8,500 < vehicle ≤ 14,000.....	\$8,500
14,000 < vehicle ≤ 26,000.....	\$17,000
26,000 < vehicle.....	\$34,000

If an electric vehicle weighing not more than 8,500 pounds has an estimated driving range of at least 100 miles on a single charge of the vehicle’s batteries or if it is capable of a payload capacity of at least 1,000 pounds, then the credit amount in Table 10 is \$5,100.

In the case of property purchased by tax-exempt persons, the seller may claim the credit. The proposal allows taxpayers to carry forward unused credits for 20 years or carry unused credits back for three (but not to any taxable year before the date of enactment).

Credit for installation of alternative fueling stations

The proposal permits taxpayers to claim a 50-percent credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property the allowable credit may not exceed \$24,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed \$800. The taxpayer’s basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed. In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2008 (January 1, 2012 in the case of hydrogen). The credit allowable in the taxable year cannot exceed the difference between the taxpayer’s regular tax (reduced by certain other credits) and the taxpayer’s tentative minimum tax. The taxpayer may carry forward unused credits for 20 years.

Credit for retail sale of alternative fuels

The proposal permits taxpayers to claim a credit equal to the gasoline gallon equivalent of 20 cents per gallon of alternative fuel sold in 2003, 30 cents per gallon in 2004, 40 cents per gallon in 2005, and 40 cents per gallon in 2006. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid mixture

consisting of at least 85 percent methanol or ethanol. The gasoline gallon equivalency of any alternative fuel is determined by reference to the British thermal unit content of the alternative fuel compared to a gallon of gasoline. The credit may be claimed for sales prior to January 1, 2007. Under the proposal, the credit is part of the general business credit.

Effective Date

The proposals relating to the credit for new fuel cell motor vehicles, hybrid motor vehicles, and alternative fuel motor vehicles, the credit for battery electric vehicles, the credit for alternative fuel vehicle refueling property, and deductions for clean fuel vehicles and clean fuel refueling property are effective for property placed in service after the date of enactment, in taxable years ending after the date of enactment. The credit for retail sales of alternative fuels is effective for sales of fuels after the date of enactment, in taxable years ending after the date of enactment.

B. Modifications to Small Producer Ethanol Credit

Present Law

Small producer credit

Present law provides several tax benefits for ethanol and methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The alcohol fuels tax credits are includible in income. This credit, like tax credits generally, 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. The alcohol fuels tax credit is scheduled to expire after December 31, 2007.

Taxation of cooperatives and their patrons

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

Description of Proposal

The proposal makes several modifications to the rules governing the small producer ethanol credit. First, the proposal liberalizes the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the proposal allows cooperatives to elect to pass-through the small ethanol producer credits to its patrons. The credit allowed to a particular patron is that proportion of the credit that the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

Third, the proposal repeals the rule that includes the small producer credit in income of taxpayers claiming it and liberalizes the ordering and carryforward/carryback rules for the small producer ethanol credit. Fourth, the proposal allows the small producer credit to be claimed against the alternative minimum tax. Finally, the proposal provides that the small producer ethanol credit is not treated as derived from a passive activity under the Code rules restricting credits and deductions attributable to such activities.

Effective Date

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

C. Tax Credit for Biodiesel Fuel Mixtures

Present Law

No income tax credit or excise tax rate reduction is provided for biodiesel fuels under present law.

However, a 52-cents-per-gallon income tax credit (the “alcohol fuels credit”) is allowed for ethanol and methanol (derived from renewable sources) when the alcohol is used as a highway motor fuel. The benefit of this income tax credit may be claimed through reductions in excise taxes paid on alcohol fuels. In the case of alcohol blended with other fuels (e.g., gasoline), the excise tax rate reductions are allowable only for blends of 90 percent gasoline/10 percent alcohol, 92.3 percent gasoline/7.7 percent alcohol, or 94.3 percent gasoline/5.7 percent alcohol. These present law provisions are scheduled to expire in 2007.

Description of Proposal

The proposal provides a new income tax credit for qualified biodiesel fuel mixtures. The structure of the new credit would be similar to structure of the present-law alcohol fuels credit. Agri-biodiesel is derived from virgin vegetable oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats, for use in diesel engines. Recycled biodiesel is derived from nonvirgin vegetable oils or animal fats for use in diesel engines. Virgin vegetable oils or animal fats mixed with recycled biodiesel will be treated as recycled biodiesel.

The per gallon biodiesel mixture credit rate for agri-biodiesel equals one cent for each percentage point of biodiesel in the fuels mixture, subject to a maximum credit of 20 cents per blended gallon of fuel. The per gallon biodiesel mixture credit rate for recycled biodiesel equals .5 cent for each percentage point of biodiesel in the fuels mixture, subject to a maximum credit of 10 cents per blended gallon of fuel. The amount of the biodiesel fuel mixture credit is includible in income. The credit may not be carried back to a taxable year beginning before date of enactment.

Agri-biodiesel used in the production of a qualified biodiesel mixture is taken into account only if a certification from the producer of the agri-biodiesel which identifies the product produced is obtained. Both agri-biodiesel and recycled biodiesel are required to meet the requirements of the Environmental Protection Agency under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and the American Society of Testing and Materials D6751.

Under the proposal, in lieu of an income tax credit for agri-biodiesel blends, a refiner blending agri-biodiesel may elect to accrue an excise tax credit equal to the amount of the biodiesel mixture credit for agri-biodiesel. An excise tax credit is not available for recycled biodiesel.

Effective Date

The biodiesel fuel mixture credit (and excise tax credit) is effective for biodiesel fuel blended after (or fuel sold after) date of enactment, and before January 1, 2006.

III. CONSERVATION AND ENERGY EFFICIENCY PROVISIONS

A. Business Credit for Construction of New Energy-Efficient Homes

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the construction of new energy-efficient homes.

Description of Proposal

The proposal provides a credit to an eligible contractor of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction. The credit cannot exceed \$1,000 (\$2,000) in the case of a new home that has a projected level of annual heating and cooling costs that is 30 percent (50 percent) less than a comparable dwelling constructed in accordance with Chapter 4 of the 2000 International Energy Conservation Code.

The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property is any energy-efficient building envelope component (insulation materials or system designed to reduce heat loss or gain, and exterior windows, including skylights, and doors) and any energy-efficient heating or cooling appliance that can, individually or in combination with other components, meet the standards for the home.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor, and (3) certified to have a projected level of annual heating and cooling

energy consumption that meets the standards for either the 30-percent or 50-percent reduction in energy usage. The home may be certified according to a component-based method or an energy performance based method. Additionally, manufactured homes certified by the Energy Star Labeled New Homes program are eligible for the \$1,000 credit provided criteria (1) and (2) are met.

The component-based method of certification shall be based on applicable energy-efficiency specifications or ratings, including current product labeling requirements. The Secretary shall develop component-based packages that are equivalent in energy performance to properties that qualify for the credit. The certification shall be provided by a third party, such as a local building regulatory authority, a utility, a manufactured home production inspection agency, or a home energy rating organization.

The performance-based method of certification shall be based on an evaluation of the home in reference to a home which uses the same energy source and system heating type, and is constructed in accordance with the Chapter 4 of the 2000 International Energy Conservation Code. The certification shall be provided by an individual recognized by the Secretary for such purposes.

The certification process requires that energy savings to the consumer be measured in terms of energy costs. To ensure consistent and reasonable energy cost analyses, the Department of Energy shall include in its rulemaking related to this bill specific reference data to be used for qualification for the credit.

The credit will be part of the general business credit. No credits attributable to energy efficient homes may be carried back to any taxable year ending on or before the effective date of the credit.

Effective Date

The credit applies to homes whose construction is substantially completed after the date of enactment and which are purchased during the period beginning on the date of enactment and ending on December 31, 2007 (December 31, 2005 in the case of the \$1,000 credit).

B. Tax Credit for Energy-Efficient Appliances

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment: (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat; or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the manufacture of energy-efficient appliances.

Description of Proposal

The proposal provides a credit for the production of certain energy-efficient clothes washers and refrigerators. The credit would equal \$50 per appliance for energy-efficient clothes washers produced with a modified energy factor ("MEF") of 1.42 MEF or greater for washers produced before 2007 and for refrigerators produced before 2005 that consume 10 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit equals \$100 for energy-efficient clothes washers produced with a MEF of 1.5 or greater and for refrigerators produced that consume at least 15 percent less kilowatt-hours per year (at least 20 percent less for production in 2007) than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit is \$150 in the case of a refrigerator that consumes at least 20 percent less kilowatt-hours per year than such standards and is produced before 2007. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

For each category of appliances (e.g., washers that meet the lower MEF standard, washers that meet the higher MEF standard, refrigerators that meet the 10 percent standard, refrigerators that meet the 15 percent standard and refrigerators that meet the 20-percent standard), only production in excess of average production for each such category during

calendar years 2000-2002 would be eligible for the credit. For 2003, only production after the date of enactment is eligible for the credit, and special rules apply to determine if production exceeds the average of the base period. The taxpayer may not claim credits in excess of \$60 million for all taxable years, and may not claim credits in excess of \$30 million with respect to appliances that only qualify for the \$50 credit. Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit will be part of the general business credit. No credits attributable to energy-efficient appliances may be carried back to taxable years ending before January 1, 2003.

Effective Date

The credit applies to appliances produced after the date of enactment and prior to January 1, 2008.

C. Credit for Residential Energy Efficient Property

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for energy efficient residential property.

Description of Proposal

The proposal provides a personal tax credit for the purchase of qualified wind energy property, qualified photovoltaic property, and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 15 percent for solar water heating property and photovoltaic property, and 30 percent for wind energy property. The maximum credit for each of these systems of property is \$2,000. The proposal also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed \$1,000 for each kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. Solar panels are treated as qualified photovoltaic property. Qualified wind energy property is property that uses wind energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and that generates at least 0.5 kilowatts of electricity. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

The proposal also provides a credit for the purchase of other qualified energy efficient property, as described below:

Electric heat pump hot water heaters with an Energy Factor of at least 1.7. The maximum credit is \$75 per unit.

Electric heat pumps with a heating efficiency of at least 9 HSPF (Heating Seasonal Performance Factor) and a cooling efficiency of at least 15 SEER (Seasonal Energy Efficiency Rating) and an energy efficiency ratio (EER) of 12.5 or greater. The maximum credit is \$250 per unit.

Natural gas furnace which achieves 95 percent annual fuel utilization efficiency. The maximum credit is \$250 per unit.

Central air conditioners with an efficiency of at least 15 SEER and an EER of 12.5 or greater. The maximum credit is \$250 per unit.

Natural gas water heaters with an Energy Factor of at least 0.8. The maximum credit is \$75 per unit.

Geothermal heat pumps which have an EER of at least 21. The maximum credit is \$250 per unit.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures. The credit is allowed against the regular and alternative minimum tax.

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. With the exception of wind energy property, if less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Effective Date

The credit applies to purchases after the date of enactment and before January 1, 2008.

D. Business Tax Incentives for Fuel Cells

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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. An unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for fuel cell power plant property.

Description of Proposal

The proposal provides a 30 percent business energy credit for the purchase of qualified fuel cell power plants for businesses. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and generates at least 0.5 kilowatts of electricity using an electrochemical process. The credit for any fuel cell may not exceed \$500 for each 0.5 kilowatts of capacity. The credit is nonrefundable. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

Effective Date

The credit for businesses applies to property placed in service after the date of enactment and before January 1, 2008, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

E. Allowance of Deduction for Energy-Efficient Commercial Building Property

Present Law

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

Description of Proposal

The proposal provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures are defined as amounts paid or incurred for energy-efficient commercial building property installed in connection with the new construction or reconstruction of property: (1) which is otherwise depreciable property; (2) which is located in the United States, and (3) the construction or erection of which is completed by the taxpayer. The deduction is limited to an amount equal to the product of \$2.25 and the square footage of the property for which such expenditures were made. No deduction is permitted unless the entire building satisfies the energy efficiency standard. The deduction is allowed in the year in which the property is placed in service.

Energy-efficient commercial building property generally means any property that reduces total annual energy and power costs with respect to the lighting, heating, cooling, ventilation, and hot water supply systems of the building by 50 percent or more in comparison to a reference building which meets the requirements of a Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers (“ASHRAE”) and the Illuminating Engineering Society of North America.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy power consumption and cost, taking into consideration provisions of the 2001 California Nonresidential Alternative Calculation Method Approval Manual or the 2001 California Residential Alternative Calculation Method Approval Manual. Additionally, the calculation methods must take into account appropriate energy savings from design methodologies and technologies not otherwise credited in either such ASHRAE Standard 90.1-2001 or in the 2001 California Nonresidential Alternative Calculation Method Approval Manual, including the following: (1) natural ventilation; (2) evaporative cooling; (3) automatic lighting controls such as occupancy sensors, photocells, and timeclocks; (4) daylighting; (5) designs utilizing semi-conditioned spaces which maintain adequate comfort conditions without air conditioning or without heating; (6) improved fan system efficiency, including reductions in static pressure; and (7) advanced unloading mechanisms for mechanical cooling, such as multiple or variable speed compressors. Additionally, the calculational methods may take into account the extent of commissioning in the building, and allow the taxpayer to take into account measured performance which exceeds typical performance.

The Secretary shall promulgate procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for

Home Energy Rating Systems. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For public property, such as schools, the Secretary will issue regulations to allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity owner. Other rules apply.

Effective Date

The provision is effective for taxable years beginning after the date of enactment for plans certified prior to December 31, 2007, whose construction is completed on or before December 31, 2009.

F. Three-Year Applicable Recovery Period for Depreciation of Qualified Energy Management Devices

Present Law

No special recovery period is currently provided for depreciation of qualified energy management devices.

Description of Proposal

The proposal provides a three-year recovery period for qualified new energy management devices placed in service by any taxpayer who is a supplier of electric energy or is a provider of electric energy services. A qualified energy management device is any tangible property eligible for accelerated depreciation under code section 168 and which

(1) is acquired and used by the taxpayer to measure and record electricity usage data on a time-differentiated basis in at least four separate time segments per day, and

(2) provides such time-differentiated electricity price and usage data on at least a monthly basis to both consumers and the supplier or provider.

Effective Date

The proposal is effective for any qualified energy management device placed in service after the date of enactment of the Act and before January 1, 2008.

G. Three-Year Applicable Recovery Period for Depreciation of Qualified Water Submetering Devices

Present Law

No special recovery period is currently provided for depreciation of qualified water submetering devices.

Description of Proposal

The proposal provides a three-year recovery period for qualified new water submetering devices placed in service by any taxpayer who is an eligible resupplier. An eligible resupplier is any taxpayer who purchases and installs qualified water submetering devices in every unit in any multi-unit property. A qualified water submetering device is any tangible property eligible for accelerated depreciation under code section 168 and which

(1) is acquired and used by the taxpayer to measure and record water usage data, and

(2) provides such water usage data on at least a monthly basis to both consumers and the supplier or provider.

Effective Date

The proposal is effective for any qualified water submetering device placed in service after the date of enactment of the Act and before January 1, 2008.

H. Energy Credit for Combined Heat and Power System Property

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Description of Proposal

The proposal provides a 10-percent credit for the purchase of combined heat and power property. CHP property is defined as property: (1) which uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) which has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) which produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities.) Also, for purposes of determining whether CHP property includes technologies which generate electricity or mechanical power using back-pressure steam turbines in place of existing pressure-reducing valves, or which make use of waste heat from industrial processes such as by using organic rankine, stirling, or kalina heat engine systems, the energy output requirements related to heat versus power described under (3), above, and the energy efficiency requirements of (4), above, may be disregarded.

CHP property does include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

If a taxpayer is allowed a credit for CHP property, and the property would ordinarily have a depreciation class life of 15 years or less, the depreciation period for the property is treated as having a 22-year class life. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to combined heat and power property may be carried back before the effective date of this provision.

Effective Date

The credit applies to property placed in service after the date of enactment and before January 1, 2007.

I. Credit for Energy Efficiency Improvements to Existing Homes

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present law credit for energy efficiency improvements to existing homes.

Description of Proposal

The proposal would provide a 10-percent nonrefundable credit for the purchase of qualified energy efficiency improvements. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is \$300. A qualified energy efficiency improvement would be any energy efficiency building envelope component that is certified to meet or exceed the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code, or any combination of energy efficiency measures that is certified to achieve at least a 30 percent reduction in heating and cooling energy usage for the dwelling and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component can reasonably be expected to remain in use for at least five years.

Building envelope components would be: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling, and (2) exterior windows (including skylights) and doors.

Homes shall be certified according to a component-based method or a performance-based method. The component-based method shall be based on applicable energy-efficiency ratings, including current product labeling requirements. Certification by the component method shall be provided by a third party, such as a local building regulatory authority, a utility, a manufactured home production inspection primary inspection agency, or a home energy rating organization. The performance-based method shall be based on a comparison of the projected energy consumption of the dwelling in its original condition and after the completion of energy efficiency measures. The performance-based method of certification shall be conducted by an individual or organization recognized by the Secretary of the Treasury for such purposes.

The certification process requires that energy savings to the consumer be measured in terms of energy costs. To ensure consistent and reasonable energy cost analyses, the Department of Energy shall include in its rulemaking related to this bill specific reference data to be used for qualification for the credit.

The taxpayer's basis in the property would be reduced by the amount of the credit. Special rules would apply in the case of condominiums and tenant-stockholders in cooperative housing corporations.

The credit is allowed against the regular and alternative minimum tax.

Effective Date

The credit is effective for qualified energy efficiency improvements installed on or after the date of enactment and before January 1, 2007.

IV. CLEAN COAL INCENTIVES

A. Investment and Production Credits for Clean Coal Technology

Present Law

Present law does not provide an investment credit for electricity generating units that use coal as a fuel. Nor does present law provide a production credit for electricity generated at units that use coal as a fuel. However, a nonrefundable, 10-percent investment tax credit (“business energy credit”) is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). Also, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste units placed in service prior to January 1, 2004 (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5 cent figure is indexed for inflation and equaled 1.8 cents for 2002. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The business energy tax credits and the production tax credit are components of the general business credit (sec. 38(b)(1)).

Description of Proposal

In general

The proposal creates three new credits: a production credit for electricity produced from qualifying clean coal technology units; a production credit for electricity produced from qualifying advanced clean coal technology units; and a credit for investments in qualifying advanced clean coal technology units. Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) will be eligible to obtain certifications from the Secretary of the Treasury (as described below) for each of these credits and sell, trade, or assign the credit to any taxpayer. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent transfers are not permitted.

Credit for investments in qualifying advanced clean coal technology units

The proposal provides a 10-percent investment tax credit for qualified investments in advanced clean coal technology units. A qualified investment is that amount that would otherwise be a qualified investment multiplied by a fraction equal to the amount of national megawatt capacity allocated to the taxpayer (as described below) divided by the megawatt capacity of the qualifying unit. Qualifying advanced clean coal technology units must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology, integrated gasification combined cycle technology, or some other technology certified by the Secretary of Energy. Any qualifying advanced clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO₂, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In

addition, a qualifying advanced clean coal technology unit must meet certain carbon emissions requirements.

The proposal defines three types of qualifying advanced clean coal technology units:
(1) advanced pulverized coal or atmospheric fluidized bed combustion technology units
(2) integrated gasification combined cycle technology units; and (3) other technology units.

- (1) A qualifying advanced pulverized coal or atmospheric fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2013 and having a design net heat rate of not more than 8,500 Btu (8,900 Btu if the unit is placed in service before 2009).
- (2) A qualifying integrated gasification combined cycle technology unit is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,350 Btu if the unit is placed in service after 2008 and before 2013).
- (3) A qualifying other technology unit use any other technology and is placed in service after the date of enactment and before 2017.

The proposal provides that qualifying advanced clean coal units must satisfy carbon emissions standards. For units using design coal with a heat content of not more than 9,000 Btu per pound, the carbon emission rate must be less than 0.60 pound of carbon per kilowatt hour (0.51 if the unit qualifies as an other technology unit). For units using design coal with a heat content in excess of 9,000 Btu per pound, the carbon emission rate must be less than 0.54 pound of carbon per kilowatt hour (0.459 if the unit qualifies as an other technology unit).

To be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 3,500 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 3,500 megawatts of capacity, not more than 1,000 megawatts in total and not more than 500 megawatts in years prior to 2009 shall be allocated to units using advanced pulverized coal or atmospheric fluidized bed combustion technology. From the potential pool of 3,500 megawatts of capacity, not more than 2,000 megawatts in total and not more than 750 megawatts in years prior to 2009 shall be allocated to units using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 3,500 megawatts of capacity, not more than 500 in total and not more than 250 megawatts in years prior to 2009 shall be allocated to any other technology certified by the Secretary of Energy.

Production credit for electricity produced from qualifying clean coal technology units

The proposal provides a production credit for electricity produced from certain units that have been retrofitted, repowered, or replaced with a clean coal technology within ten years of the date of enactment. The value of the credit is 0.34 cents per kilowatt-hour of electricity and the

heat value of other fuels or chemicals produced at the unit³ multiplied by the fraction equal to the amount of national megawatt capacity limitation (see below) allocated to the qualifying unit divided by the total megawatt capacity of the unit. The value of the credit is indexed for inflation occurring after 2003 with the first potential adjustment in 2005. The taxpayer may claim the credit throughout the ten-year period commencing from the date on which the qualifying unit is placed in service.

A qualifying clean coal technology unit is a clean coal technology unit that meets certain capacity standards, thermal efficiency standards, and emissions standards for SO₂, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying clean coal technology unit cannot be a unit that is receiving or is scheduled to receive funding under the Clean Coal Technology Program, the Power Plant Improvement Initiative, or the Clean Coal Power Initiative administered by the Secretary of the Department of Energy. Lastly, to be a qualified clean coal technology unit, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to units only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. However, no qualifying unit would be eligible if the unit's capacity exceeded 300 megawatts prior to having been retrofitted, repowered, or replaced. The maximum eligible allocation to any qualifying unit may not exceed 300 megawatts.

Production credit for electricity produced from qualifying advanced clean coal technology

The proposal also provides a production credit for electricity produced from any qualified advanced clean coal technology electricity generation unit that qualifies for the investment credit for qualifying clean coal technology units, as described above.⁴ The taxpayer may claim a production credit on the sum of each kilowatt-hour of electricity produced and the heat value of other fuels or chemicals produced by the taxpayer at the unit.⁵ The taxpayer may claim the production credit for the 10-year period commencing with the date the qualifying unit is placed in service (or the date on which a conventional unit was retrofitted or repowered). The value of the credit varies depending upon the year the unit is placed in service, whether the unit produces solely electricity or electricity and fuels or chemicals, and the rated thermal efficiency of the unit. In addition, the value of the credit is reduced for the second five years of eligible production. If a unit meets the more stringent qualification standards of post-2008 in years before 2009, the taxpayer may claim the higher post-2008 credit amounts. The value of the

³ Each 3,413 Btu of heat content of the fuel or chemical is treated as equivalent to one kilowatt-hour of electricity.

⁴ In the case of a taxpayer who received a megawatt allocation for a qualifying advanced clean coal technology unit that is less than the rated capacity of such unit, the taxpayer may claim credit on a percentage of the electricity produced from the unit. The percentage is the percentage that the taxpayer's megawatt allocation represents as a percentage of the rated capacity of the unit.

⁵ Each 3,413 Btu of heat content of the fuel or chemical is treated as equivalent to one kilowatt-hour of electricity.

credit is indexed for inflation occurring after 2003 with the first potential adjustment in 2005. The tables below specify the value of the credit (before indexing is applied).

Advanced clean coal technology units producing solely electricity

Table 11.—Units Placed in Service Before 2009

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 8,500	\$.0060	\$.0038
More than 8,500 but not more than 8,750	\$.0025	\$.0010
More than 8,750 but less than 9,000	\$.0010	\$.0010

Table 12.—Units Placed in Service After 2008 and Before 2013

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 7,770	\$.0105	\$.0090
More than 7,770 but not more than 8,125	\$.0085	\$.0068
More than 8,125 but less than 8,350	\$.0075	\$.0055

Table 13.—Units Placed in Service After 2012 and Before 2017

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 7,380	\$.0140	\$.0115
More than 7,380 but not more than 7,720	\$.0120	\$.0090

Advanced clean coal technology units producing electricity and a fuel or chemical

Table 14.—Units Placed in Service Before 2009

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 40.6%	\$.0060	\$.0038
Less than 40.6% but not less than 40%	\$.0025	\$.0010
Less than 40% but not less than 38.4%	\$.0010	\$.0010

Table 15.—Units Placed in Service After 2008 and Before 2013

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 43.6%	\$.0105	\$.0090
Less than 43.6% but not less than 42%	\$.0085	\$.0068
Less than 42% but not less than 40.2%	\$.0075	\$.0055

Table 16.—Units Placed in Service After 2012 and Before 2017

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 44.2%	\$.0140	\$.0115
Less than 44.2% but not less than 43.9%	\$.0120	\$.0090

The credits are part of the general business credit. No credit may be carried back to taxable years ending on or before the date of enactment.

Effective Date

The proposal relating to investment credits for advanced clean coal technology units is effective after the date of enactment. The proposal relating to production credits are effective after the date of enactment.

V. OIL AND GAS PROVISIONS

A. Tax Credit for Oil and Gas Production from Marginal Wells

Present Law

There is no credit for the production of oil and gas from marginal wells. The costs of such production may be recovered under the Code's depreciation and depletion rules and in other cases as a deduction for ordinary and necessary business expenses.

Description of Proposal

The provision would create a new, \$3 per barrel credit for the production of crude oil and a \$0.50 credit per 1,000 cubic feet of qualified natural gas production. The maximum amount of production on which credit could be claimed is 1,095 barrels or barrel equivalents. In both cases, the credit is available only for production from a "qualified marginal well." The credit is not available to production occurring if the reference price of oil exceeded \$18 (\$2.00 for natural gas). The credit is reduced proportionately as for reference prices between \$15 and \$18 (\$1.67 and \$2.00 for natural gas). Reference prices are determined on a one-year look-back basis.

A qualified marginal well is defined as (1) a well production from which was marginal production for purposes of the Code percentage depletion rules or (2) a well that during the taxable year had (a) average daily production of not more than 25 barrel equivalents and (b) produced water at a rate of not less than 95 percent of total well effluent.

The credit is treated as part of the general business credit. The credit cannot be carried back to a taxable year ending on or before the date of enactment of the proposal.

Effective Date

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

B. Natural Gas Gathering Lines Treated as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.⁶ Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. The 10th Circuit Court of Appeals held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., seven-year recovery period).⁷ More recently, the Tax Court and the U.S. District Court for the Eastern District of Michigan, Southern Division, held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 46.0 (i.e., 15-year recovery period).⁸

Description of Proposal

The proposal establishes a statutory seven-year recovery period and a class life of 10 years for natural gas gathering lines. A natural gas gathering line is defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

Effective Date

The proposal is effective for property placed in service after the date of enactment. No inference is intended as to the proper treatment of natural gas gathering lines placed in service before the date of enactment.

⁶ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

⁷ *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 T.C. 416 (1997). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

⁸ *Clajon Gas Co., L.P. v. Commissioner*, 119 T.C. 197 (2002) and *Saginaw Bay Pipeline Co. v. United States*, 124 F. Supp. 2d 465 (E.D. Mich. 2001).

C. Expensing of Capital Costs Incurred and Credit for Production in Complying with Environmental Protection Agency Sulfur Regulations

Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. Present law does not provide a credit for the production of low-sulfur diesel fuel.

Description of Proposal

The proposal generally permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the qualified capital costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency. Qualified capital costs are those costs paid or incurred and otherwise chargeable to the taxpayer's capital account that are necessary for the refinery to come into compliance with the EPA diesel fuel requirements.

In addition, the proposal provides that a small business refiner may claim a credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced at a facility of a small business refiner. The total production credit claimed by the taxpayer generally is limited to 25 percent of the qualified capital costs incurred with respect to expenditures at the refinery during the period beginning after the date of enactment and ending with the date that is one year after the date on which the taxpayer must comply with applicable EPA regulations. No deduction is allowed to the taxpayer for expenses otherwise allowable as a deduction in an amount equal to the amount of production credit claimed during the taxable year.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products employs not more than 1,500 employees directly in refining on business days during a taxable year in which the deduction or production credit is claimed and had an average daily refinery run (or retained production) not exceeding 205,000 barrels per day for the year prior to enactment.

For taxpayers with an average daily refinery run in the year prior to enactment in excess of 155,000 and not greater than 205,000 barrels per day, the provision limits otherwise qualifying small business refiners to an immediate deduction for a percentage of qualifying capital costs equal to 75 percent less the percentage points determined by the excess of the average daily refinery runs over 155,000 barrels per day divided by 50,000 barrels per day. In addition, for these taxpayers, the limitation on the total production credit that may be claimed also is reduced proportionately.

In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization.

Effective Date

The proposal is effective for expenses paid or incurred after December 31, 2002.

D. Determination of Small Refiner Exception to Oil Depletion Deduction

Present Law

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides numerous special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deductions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.

Description of Proposal

The proposal increases the current 50,000-barrel-per-day limitation to 60,000. In addition, the proposal changes the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery run for the taxable year cannot exceed 60,000 barrels. For this purpose, the taxpayer calculates average daily refinery run by dividing total production for the taxable year by the total number of days in the taxable year.

Effective Date

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

E. Extension of Suspension of Taxable Income Limit With Respect to Marginal Production

Present Law

In general

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

Depletion is available to any person having an economic interest in a producing property. 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.⁹ 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 Internal Revenue Code (the "Code"): (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

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.¹⁰ 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 (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). By contrast, for any other mineral qualifying for the percentage depletion deduction,

⁹ Treas. Reg. sec. 1.611-1(b)(1).

¹⁰ Sec. 613A.

such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, effective for taxable years beginning after 1990. 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.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).¹¹ Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

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

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

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,¹² are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Description of Proposal

The suspension of the 100-percent net-income limitation for marginal wells is extended through taxable years beginning before January 1, 2007.

¹¹ Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

¹² This exception is limited to wells, the drilling of which began between September 30, 1978, and January 1, 1984.

Effective Date

The proposal is effective on date of enactment.

F. Amortization of Geological and Geophysical Expenditures

Present Law

In general

Geological and geophysical expenditures are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.¹³

Courts have held that geological and geophysical costs are capital, and therefore are allocable to the cost of the property¹⁴ acquired or retained.¹⁵ The costs attributable to such exploration are allocable to the cost of the property acquired or retained. As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of geological and geophysical costs.

Revenue Ruling 77-188

In Revenue Ruling 77-188¹⁶ (hereinafter referred to as the “1977 ruling”), the IRS provided guidance regarding the proper tax treatment of geological and geophysical costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each

¹³ Under section 263, capital expenditures are defined generally as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treasury regulations define capital expenditures to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. Treas. Reg. sec. 1.263(a)-1(b).

¹⁴ “Property” means an interest in a property as defined in section 614 of the Code, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proved at the time the costs are incurred.

¹⁵ See, e.g., *Schermerhorn Oil Corporation v. Commissioner*, 46 B.T.A. 151 (1942). By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

¹⁶ 1977-1 C.B. 76.

project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.
- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate “area of interest.” The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.
- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

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

If no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the geological and geophysical costs related to the exploration is deductible as a loss under section 165. The loss is claimed in the taxable year in which that particular project area is abandoned as a potential source of mineral production.

A taxpayer may acquire or retain a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Generally, under the 1977 ruling, the taxpayer

allocates the entire amount of geological and geophysical costs to the acquired or retained property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount of the geological and geophysical costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the geological and geophysical costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83-105,¹⁷ which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes “abandonment as a potential source of mineral production.”

Description of Proposal

The proposal allows geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be amortized over four years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the four-year amortization period.

Effective Date

The proposal is effective for geological and geophysical costs paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date geological and geophysical costs.

¹⁷ 1983-2 C.B. 51.

G. Amortization of Delay Rental Payments

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 263). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for “delay rental payments” as a condition of their extension. In proposed regulations issued in 2000, the Treasury Department took the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.¹⁸

Description of Proposal

The proposal allows delay rental payments incurred in connection with the development of oil or gas within the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

Effective Date

The proposal applies to delay rental payments paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

¹⁸ 65 Fed. Reg. 6090 (2000).

H. Extension and Modification of Credit for Producing Fuel From a Non-Conventional Source

Present Law

Certain fuels produced from “non-conventional sources” and sold to unrelated parties are eligible for an income tax credit equal to \$3 (generally adjusted for inflation)¹⁹ per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

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

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

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

Description of Proposal

In general

The proposal extends the placed in service date for certain facilities that would otherwise qualify for the section 29 credit under present law and modifies the amount of the credit. The proposal also expands the class of facilities that are eligible for the credit. In addition, under the proposal, the taxpayer would not be able to claim any credit for production in excess of a daily average of 200,000 cubic feet of gas (or barrel of oil equivalent) from a qualifying well or facility.²⁰

¹⁹ The value of the section 29 credit for production in 2001 was \$6.28 per barrel of oil equivalent.

²⁰ The daily average would be computed as total production divided by the total number of days the well or facility was in production during the year.

Extension for certain non-conventional fuels

The proposal permits taxpayers to claim the section 29 credit for production of certain non-conventional fuels produced at wells placed in service after the date of enactment and before January 1, 2007.²¹ Under the proposal, qualifying fuels are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass. The value of the credit is re-based to \$2.00 and the amount is not indexed for inflation. Taxpayers may claim the credit for production from the well for each of the first three years of production from the qualifying well.

Expansion for fuels from agricultural and animal waste

The proposal adds facilities producing liquid, gaseous, or solid fuels, from agricultural and animal waste placed in service after the date of enactment and before January 1, 2007, to the list of qualified facilities for purposes of the non-conventional fuel credit. The amount of the credit is equal to \$3 (unindexed) per barrel or Btu oil barrel equivalent, for three years of production commencing on the date the facility is placed in service. Agricultural and animal waste includes by-products, packaging, and any materials associated with processing, feeding, selling, transporting, or disposal of agricultural or animal products or wastes, including wood shavings, straw, rice hulls, and other bedding for the disposition of manure.

Expansion for “viscous oil”

The proposal expands section 29 to permit taxpayers to claim the section 29 credit for production of certain viscous oil produced at wells placed in service after the date of enactment and before January 1, 2007. The proposal defines “viscous oil” as domestic crude oil produced from any property if the crude oil has a weighted average gravity of 22 degrees API or less (corrected to 60 degrees Fahrenheit). The value of the credit for viscous oil also is \$3.00 per barrel. Taxpayers may claim the credit for production from the well for each of the first three years of production from the time the well is placed in service. The proposal provides that qualifying sales to related parties for consumption not in the immediate vicinity of the wellhead qualify for the credit.

Expansion for “refined coal”

The proposal also expands section 29 to include certain “refined coal” as a qualified non-conventional fuel. “Refined coal” is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) from facilities placed in service after date of enactment and before January 1, 2007. Refined coal also would include a qualifying fuel derived from high-carbon fly ash produced from facilities placed in service after the date of enactment and before January 1, 2007. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxide and either sulfur dioxide or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the

²¹ The proposal does not apply to liquid, gaseous, or solid synthetic fuels produced from coal as described under present law section 29(c)(1)(C), but does provide credit for a new category, refined coal, described below.

fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. However, no fuel produced at a qualifying advanced clean coal facility (as defined elsewhere in the committee bill) would be a qualifying fuel. The amount of credit for refined coal also is \$3.00 per barrel equivalent. Taxpayers may claim the credit for fuel produced during the five-year period beginning on the date the facility is placed in service.

Expansion for coalmine gas

In addition, the proposal permits taxpayers to claim credit for coalmine gas captured by the taxpayer and utilized as a fuel source or sold by or on behalf of the taxpayer to an unrelated person. The term “coalmine gas” means any methane gas which is being liberated during qualified coal mining operations or as a result of past qualified coal mining operations, or which is captured in advance of qualified coal mining operations as part of specific plan to mine a coal deposit. In the case of coalmine gas that is captured in advance of qualified coal mining operations, the credit is allowed only after the date the coal extraction occurs in the immediate area where the coalmine gas was removed. The value of the credit for coalmine methane also is \$3.00 per Btu oil barrel equivalent (51.7 cents per million Btu of heat value in the gas) for gas captured and utilized or sold. Taxpayers may claim the credit for gas captured and utilized or sold after the date of enactment and before January 1, 2007.

Extension of credit for certain existing facilities

The proposal extends the present-law credit through December 31, 2005 for production from existing facilities producing coke, coke gas, or natural gas and by-products produced by coal gasification from lignite. The proposal provides that the credit amount will be \$3.00 per Btu oil barrel equivalent for production from such facilities after December 31, 2002.

Study of coal bed methane gas

Lastly, the proposal directs the Secretary of the Treasury to undertake a study of effect section 29 has had on the production of coal bed methane. The Secretary’s study is to be made in conjunction with the study to be undertaken by the Secretary of the Interior on the effects of coal bed methane production on surface and water resources, as provided in section 608 of the Energy Policy Act of 2002 (should that study be required by law). The study should estimate the total amount of credit claimed annually and in aggregate related to the production of coal bed methane since the enactment of section 29. The study should report the annual value of the credit allowable for coal bed methane compared to the average annual wellhead price of natural gas (per thousand cubic feet of natural gas). The study should estimate the incremental increase in production of coal bed methane that has resulted from the enactment of section 29. The study should estimate the cost to the Federal government, in terms of the net tax benefits claimed, per thousand cubic feet of incremental coal bed methane produced annually and in aggregate since the enactment of section 29.

Effective Date

The proposals apply to fuels sold from qualifying wells and facilities after the date of enactment.

I. Natural Gas Distribution Lines Treated as Fifteen-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.²² Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a class life of 20 years for natural gas distribution lines.

Effective Date

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

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

VI. PROVISIONS RELATING TO ELECTRIC INDUSTRY RESTRUCTURING

A. Modification to Special Rules for Nuclear Decommissioning Costs

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 (“1984 Act”), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a “qualified fund”) is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.²³

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the “cost of service requirement”).²⁴ Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer’s income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant’s estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such

²³ As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

²⁴ Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the “ruling amount”). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor’s basis in the fund.²⁵ The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.²⁶

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.²⁷ The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund’s owner as it is earned.

Description of Proposal

Repeal of cost of service requirement

The proposal repeals the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

Clarify treatment of transfers of qualified funds

The proposal clarifies the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee (or the qualified fund) as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established.

²⁵ Treas. reg. sec. 1.468A-6.

²⁶ Treas. reg. sec. 1.468A-6(f).

²⁷ These funds are generally referred to as “nonqualified funds.”

Exception to ruling amount for certain decommissioning costs

The proposal permits a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of the amount required to fund a nuclear powerplant's decommissioning costs which, under present law, is not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).²⁸ It is anticipated that an amount that is permitted to be contributed under this special rule shall be determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule that has not previously been deducted, or excluded from gross income is allowed as a deduction over the remaining useful life of the nuclear powerplant.²⁹ If a qualified fund that has received amounts under this rule is transferred to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Thus, if the transferor was not subject to tax at the time and thus would have been unable to use the deduction, the transferee will similarly not be able to utilize the deduction.

Effective Date

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

²⁸ The ability to transfer property into a qualified fund under this special rule is available only to the extent the taxpayer has not obtained a new ruling amount incorporating the repeal of the limitation that a qualified fund only accumulate an amount sufficient to pay for decommissioning costs of a nuclear powerplant incurred during the period that the fund is in existence (generally post 1984 decommissioning costs).

²⁹ A taxpayer recognizes no gain or loss on the contribution of property to a qualified fund under this special rule. The qualified fund will take a transferred (carryover) basis in such property. Correspondingly, a taxpayer's deduction (over the estimated life of the nuclear powerplant) is to be based on the adjusted tax basis of the property contributed rather than the fair market value of such property.

B. Treatment of Certain Income of Cooperatives

Present Law

In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from the cooperative; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).³⁰

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code (sec. 1381, *et seq.*) are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative (sec. 1382). The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative (sec. 521).

³⁰ Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

Taxation of electric cooperatives exempt from subchapter T

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (sec. 1381(a)(2)(C)). Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.³¹

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).³² The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the Federal Government. Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under section 511.

Description of Proposal

Treatment of income from open access transactions

The proposal provides that income received or accrued by a rural electric cooperative from any "open access transaction" (other than income received or accrued directly or indirectly from a member of the cooperative) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "open access transaction" is defined as--

- (1) the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis: (i) pursuant to an open access transmission tariff filed with and approved by the Federal Energy Regulatory Commission ("FERC") (including acceptable reciprocity tariffs), but only if (in the case of a voluntarily filed tariff) the cooperative files a report with FERC

³¹ See Rev. Rul. 83-135, 1983-2 C.B. 149.

³² Rev. Rul. 72-36, 1972-1 C.B. 151.

within 90 days of enactment of this provision relating to whether or not the cooperative will join a regional transmission organization (“RTO”); or (ii) under an RTO agreement approved by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities),³³

- (2) the provision or sale of electric energy distribution services or ancillary services on a nondiscriminatory open access basis to end-users served by distribution facilities owned by the cooperative or its members; or
- (3) the delivery or sale of electric energy on a nondiscriminatory open access basis, provided that such electric energy is generated by a generation facility that is directly connected to distribution facilities owned by the cooperative (or its members) which owns the generation facility.

For purposes of the 85-percent test, the proposal also provides that income received or accrued by a rural electric cooperative from any “open access transaction” is treated as an amount collected from members for the sole purpose of meeting losses and expenses if the income is received or accrued indirectly from a member of the cooperative.

Treatment of income from nuclear decommissioning transactions

The proposal provides that income received or accrued by a rural electric cooperative from any “nuclear decommissioning transaction” also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term “nuclear decommissioning transaction” is defined as--

- (1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative’s interest in a nuclear powerplant or nuclear powerplant unit;
- (2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or
- (3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

Treatment of income from asset exchange or conversion transactions

The proposal provides that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement

³³ Under this provision, references to FERC are treated as including references to the Public Utility Commission of Texas or the Rural Utilities Service.

property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or natural gas.

Treatment of cancellation of indebtedness income from prepayment of certain loans

The proposal provides that income from the prepayment of any loan, debt, or obligation of a tax-exempt rural electric cooperative that is originated, insured, or guaranteed by the Federal Government under the Rural Electrification Act of 1936 is excluded in determining whether the cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

Treatment of income from load loss transactions

Tax-exempt rural electric cooperatives.—The proposal provides that income received or accrued by a tax-exempt rural electric cooperative from a “load loss transaction” is treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Therefore, income from load loss transactions is treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The proposal also provides that income from load loss transactions does not cause a tax-exempt electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term “load loss transaction” is generally defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a seven-year period beginning with the “start-up year” does not exceed the reduction in the amount of sales of electric energy during such period by the cooperative to members. The “start-up year” is defined as the calendar year which includes the date of enactment of this provision or, if later, at the election of the cooperative: (1) the first year that the cooperative offers nondiscriminatory open access; or (2) the first year in which at least 10 percent of the cooperative’s sales of electric energy are to patrons who are not members of the cooperative.

The proposal also excludes income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

Taxable electric cooperatives.—The proposal provides that the receipt or accrual of income from load loss transactions by taxable electric cooperatives is treated as income from patrons who are members of the cooperative. Thus, income from a load loss transaction is excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative. The proposal also provides that income from load loss transactions does not cause a taxable electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

Effective Date

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

C. Sales or Dispositions to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy

Present Law

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

Description of Proposal

The proposal permits a taxpayer to elect to recognize gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale. A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company³⁴ prior to January 1, 2008.

A taxpayer electing the provisions of the proposal is required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in the manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years.³⁵

Effective Date

The proposal is effective for transactions occurring after the date of enactment.

³⁴ In general, an independent transmission company is defined as: (1) a regional transmission organization approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved regional transmission organization before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the exclusive jurisdiction of the Public Utility Commission of Texas, a person who is approved by that commission as consistent with Texas state law regarding an independent transmission organization.

³⁵ The proposal also provides that the installment sale rules shall not apply to any qualifying electric transmission transaction that elects the provisions of this proposal.

VII. ADDITIONAL PROVISIONS

A. Extension of Accelerated Depreciation and Wage Credit Benefits on Indian Reservations

Present Law

Present law includes the following tax incentives for businesses located within Indian reservations.

Accelerated depreciation

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, 2004.

Indian employment credit

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 December 31, 2003.

Explanation of Provision

Accelerated depreciation

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

Indian employment credit

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

Effective Date

The provision is effective on the date of enactment.

B. GAO Study

Present Law

Present law does not require study of the present law provisions relating to clean fuel vehicles and electric vehicles.

Description of Proposal

The proposal directs the Comptroller General to undertake an ongoing analysis of the effectiveness of the tax credits allowed to alternative motor vehicles and the tax credits allowed to various alternative fuels under Title II of the bill and the tax credits and enhanced deductions allowed for energy conservation and efficiency under Title III of the bill. The studies should estimate the energy savings and reductions in pollutants achieved from taxpayer utilization of these provisions. The studies should estimate the dollar value of the benefits of reduced energy consumption and reduced air pollution in comparison to estimates of the revenue cost of these provisions to the U.S. Treasury. The studies should include an analysis of the distribution of the taxpayers who utilize these provisions by income and other relevant characteristics.

The proposal directs the Comptroller General to submit annual reports to Congress beginning not later than December 31, 2004.

Effective Date

The proposal is effective on the date of enactment.