JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 4520), to amend the Internal Revenue Code of 1986 to remove impediments in such Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment that is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

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TITLE I – PROVISIONS RELATING TO REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME

A. Repeal of Extraterritorial Income Regime (sec. 101 of the House bill, sec. 101 of the Senate amendment, and secs. 114 and 941 through 943 of the Code)

Present Law

Like many other countries, the United States has long provided export-related benefits under its tax law. In the United States, for most of the last two decades, these benefits were provided under the foreign sales corporation ("FSC") regime. In 2000, the European Union succeeded in having the FSC regime declared a prohibited export subsidy by the World Trade Organization ("WTO"). In response to this WTO finding, the United States repealed the FSC rules and enacted a new regime, under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.[1] The European Union immediately challenged the extraterritorial income ("ETI") regime in the WTO, and in January of 2002 the WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

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

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[1] Transition rules delayed the repeal of the FSC rules and the effective date of ETI for transactions before January 1, 2002. An election was provided, however, under which taxpayers could adopt ETI at an earlier date for transactions after September 30, 2000. This election allowed the ETI rules to apply to transactions after September 30, 2000, including transactions occurring pursuant to pre-existing binding contracts.

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

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

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

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

House Bill

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

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

Effective date.–The provision is effective for transactions after December 31, 2004.

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[4] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract. For this purpose, a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

Senate Amendment

The provision repeals the exclusion for extraterritorial income. However, the provision provides that the extraterritorial income exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003, and at all times thereafter.

The provision permits foreign corporations that have elected to be treated as U.S. corporations pursuant to the extraterritorial income exclusion provisions to revoke their elections. Such revocations are effective on the date of enactment of this provision. A corporation revoking its election is treated as a U.S. corporation that transfers all of its property to a foreign corporation in connection with an exchange described in section 354 of the Code. In general, the corporation shall not recognize any gain or loss on such deemed transfer. However, a revoking corporation shall recognize any gain on any asset held by the corporation if: (1) the basis of such asset is determined (in whole or in part) by reference to the basis of such asset in the hands of the person from whom the corporation acquired such asset; (2) the asset was acquired by an actual transfer (rather than as a result of the U.S. corporation election by the corporation) occurring on or after the first day on which the U.S. corporation election by the corporation was effective; and (3) a principal purpose of the acquisition was the reduction or avoidance of tax.

The provision also provides a deduction for taxable years of certain corporations ending after the date of enactment of the provision and beginning before January 1, 2007.[5] The amount of the deduction for each such taxable year is equal to a specified percentage of the amount that, for the taxable year of a corporation beginning in 2002, was excludable from the gross income of the corporation under the extraterritorial income exclusion provisions or was treated by the corporation as exempt foreign trade income of related FSCs from property acquired by the FSCs from the corporation.[6] However, this aggregate amount does not include any amount attributable to a transaction involving a lease by the corporation unless the corporation manufactured or produced (in whole or in part) the leased property.

The specified percentage to be used in determining the deduction is: 80 percent for calendar years 2004 and 2005; 60 percent for calendar year 2006; and 0 percent for calendar years 2007 and thereafter. For calendar year 2003, the specified percentage is the amount that bears the same ratio to 100 percent as the number of days after the date of enactment of this provision bears to 365. In the case of a corporation with a taxable year that is not the calendar

[5] The deduction also is available to cooperatives engaged in the marketing of agricultural or horticultural products.

[6] In the case of a short taxable year that ends after the date of enactment and begins before January 1, 2007, the Treasury Secretary shall prescribe guidance for determining the amount of the deduction, including guidance that limits the amount of the deduction for a short taxable year based upon the proportion that the number of days in the short taxable year bears to 365.

year (i.e., a fiscal year corporation), a special rule is provided for determining a weighted average specified percentage based upon the calendar years that are included in the taxable year.

The deduction for a taxable year generally is reduced by the specified percentage of exempted FSC income and excluded extraterritorial income of the corporation for the taxable year from transactions pursuant to a binding contract.

Effective date.–The provision is effective for transactions occurring after the date of enactment.

Conference Agreement

The conference agreement follows the House bill, except that under the conference agreement the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract[7] between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003, and at all times thereafter.

Effective date.–The effective date is the same as the House bill.

[7] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract. For this purpose, a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

B. Deduction Relating to Income Attributable to United States Production Activities (sec. 102 of the House bill, secs. 102 and 103 of the Senate amendment, and sec. 11 of the Code)

Present Law

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

Table 1.--Marginal Federal Corporate Income Tax Rates for 2004

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

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

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

House Bill

In general

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

Qualified production activities income

"Qualified production activities income" is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[8]

[8] The House bill provides that Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to

Domestic production gross receipts

Under the House bill, "domestic production gross receipts" generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;[9] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction, engineering or architectural services performed in the United States for construction projects located in the United States. However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[10]

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

Under the House bill, an election under section 631(a) made by a corporate taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year

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domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

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

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

ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2004.

Senate Amendment

In general

The Senate amendment provides a deduction equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2008, the Senate amendment deduction is nine percent of such income. For taxable years beginning in 2004, 2005, 2006, 2007 and 2008, the deduction is five, five, five, six, and seven percent of income, respectively. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during such taxable year.[11] In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer.

Qualified production activities income

In general, "qualified production activities income" under the Senate amendment is the modified taxable income[12] of a taxpayer that is attributable to domestic production activities. Income attributable to domestic production activities generally is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;[13] (2) other deductions, expenses, or losses that are directly allocable to such receipts;

[11] For purposes of the Senate amendment, "wages" include the sum of the aggregate amounts of wages (as defined in section 3401(a) without regard to exclusions for remuneration paid for services performed in possessions of the United States) and elective deferrals that the taxpayer is required to include on statements with respect to the employment of employees of the taxpayer during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A). Any wages taken into account for purposes of determining the wage limitation under the Senate amendment cannot also be taken into account for purposes of determining any credit allowable under sections 30A or 936.

[12] "Modified taxable income" under the Senate amendment is taxable income of the taxpayer computed without regard to the deduction provided by the Senate amendment. Qualified production activities income is limited to the modified taxable income of the taxpayer.

[13] For purposes of determining such costs under the Senate amendment, any item or service that is imported into the United States without an arm's length transfer price shall be treated as acquired by purchase, and its cost shall be treated as not less than its fair market value when it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. With regard to property previously exported by the taxpayer for further manufacture,

and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[14]

For taxable years beginning before 2013, the Senate amendment provides that qualified production activities income is reduced by virtue of a fraction (not to exceed one), the numerator of which is the value of the domestic production of the taxpayer and the denominator of which is the value of the worldwide production of the taxpayer (the "domestic/worldwide fraction").[15] For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is reduced by 25, 50, and 75 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

Domestic production gross receipts

Under the Senate amendment, "domestic production gross receipts" are gross receipts of a taxpayer that are derived in the actual conduct of a trade or business from any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the taxpayer within the United States or any possession of the United States.[16] Such term also includes a

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the increase in cost or adjusted basis shall not exceed the difference between the fair market value of the property when exported and the fair market value of the property when re-imported into the United States after further manufacture.

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

[15] For purposes of the domestic/worldwide fraction under the Senate amendment, the value of domestic production is the excess of domestic production gross receipts (as defined below) over the cost of deductible purchased inputs that are allocable to such receipts. Similarly, the value of worldwide production is the excess of worldwide production gross receipts over the cost of deductible purchased inputs that are allocable to such receipts. For purposes of determining the domestic/worldwide fraction, purchased inputs include: purchased services (other than employees) used in manufacture, production, growth, or extraction activities; purchased items consumed in connection with such activities; and purchased items incorporated as part of the property being manufactured, produced, grown, or extracted. In the case of corporate taxpayers that are members of certain affiliated groups, the domestic/worldwide fraction is determined by treating all members of such groups as a single taxpayer.

[16] Under the Senate amendment, domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (but not transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

percentage of gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States.[17] Finally, such term includes gross receipts derived by the taxpayer from the use of film and videotape property produced in whole or in significant part by the taxpayer within the United States. "Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(3) or (4) of the Code.[18] However, qualifying production property does not include: (1) consumable property that is sold, leased or licensed as an integral part of the provision of services; (2) oil or gas (other than certain primary products thereof);[19] (3) electricity; (4) water supplied by pipeline to the consumer; (5) utility services; and (6) any film, tape, recording, book, magazine, newspaper or similar property the market for which is primarily topical or otherwise essentially transitory in nature.[20]

Other rules

Qualified production activities income of passthrough entities (other than cooperatives)

With respect to domestic production activities of an S corporation, partnership, estate, trust or other passthrough entity (other than an agricultural or horticultural cooperative), the

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[17] For taxable years beginning in 2004 through 2008, the applicable percentage is 25%. For taxable years beginning in 2009 through 2012, the applicable percentage is 50%. For taxable years beginning after 2012, the applicable percentage is 100%.

[18] For purposes of the definition of qualified production property under the Senate amendment, property described in section 168(f)(3) or (4) of the Code includes underlying copyrights and trademarks. In addition, gross receipts from the sale, exchange, lease, rental, license or other disposition of property described in section 168(f)(3) or (4) are treated as domestic production gross receipts if more than 50 percent of the aggregate development and production costs of such property are incurred by the taxpayer within the United States. For this purpose, property that is acquired by the taxpayer after development or production has commenced, but before such property generates substantial gross receipts, shall be treated as developed or produced by the taxpayer.

[19] Under the Senate amendment, qualifying production property does not include extracted but unrefined oil or gas, but generally includes primary products of oil and gas that are produced by the taxpayer. Examples of primary products for this purpose include motor fuels, chemical feedstocks and fertilizer. However, primary products do not include the output of a natural gas processing plant. Natural gas processing plants generally are located at or near the producing gas field that supplies the facility, and the facility serves to separate impurities from the natural gas liquids recovered from the field for the purpose of selling the liquids for future production and preparation of the natural gas for pipeline transportation.

[20] The topical and transitory exclusion does not apply to the extent of the gross receipts from the use of film and videotape property produced in whole or in significant part by the taxpayer within the United States.

deduction under the Senate amendment generally is determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity.[21] The Senate amendment directs the Secretary to prescribe rules for the application of the deduction to passthrough entities, including reporting requirements and rules relating to restrictions on the allocation of the deduction to taxpayers at the partner or similar level.

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the Senate amendment provides the same treatment of qualified production activities income derived from products marketed through cooperatives as it provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income). In addition, the Senate amendment provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the Senate amendment, is excludible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income under section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

Separate application to films and videotape

Under the Senate amendment, the deduction provided by this provision with respect to films and videotape is determined separately with respect to qualified production activities income of the taxpayer allocable to each of three markets: theatrical, broadcast television, and home video. The Senate amendment provides rules for making a separate determination of qualified production activities allocable to each market.

Alternative minimum tax

The deduction provided by the Senate amendment is allowed for purposes of the alternative minimum tax (including adjusted current earnings). The deduction is determined by reference to modified alternative minimum taxable income.

Coordination with ETI repeal

For purposes of the Senate amendment, domestic production gross receipts does not include gross receipts from any transaction that produces excluded extraterritorial income pursuant to the binding contract exception to the ETI repeal provisions of the Senate amendment.

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[21] However, the wage limitation described above is determined at the entity level in computing the deduction with respect to qualified production activities income of a passthrough entity.

Qualified production activities income is determined without regard to any deduction provided by the ETI repeal provisions of the Senate amendment.

Effective date.–The Senate amendment provision is effective for taxable years ending after the date of enactment.

Conference Agreement

In general

The conference agreement provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is equal to nine percent of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.[22] In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer and the deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income.

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;[23] (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a

[22] For purposes of the conference agreement, "wages" include the sum of the aggregate amounts of wages and elective deferrals that the taxpayer is required to include on statements with respect to the employment of employees of the taxpayer during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

[23] For purposes of determining such costs, any item or service that is imported into the United States without an arm's length transfer price shall be treated as acquired by purchase, and its cost shall be treated as not less than its value when it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. With regard to property previously exported by the taxpayer for further manufacture, the increase in cost or adjusted basis shall not exceed the difference between the value of the property when exported and the value of the property when re-imported into the United States after further manufacture. Except as provided by the Secretary, the value of property for this purpose shall be its customs value (as defined in section 1059A(b)(1)).

proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[24]

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;[25] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[26] or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

However, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment,[27] or (2) the transmission or distribution of electricity, natural gas, or potable

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[24] The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., sec. 263A, in determining the cost of goods sold, and sec. 861, in determining the source of such items). Other deductions, expenses or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses.

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

[26] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting.

[27] The conferees intend that food processing, which generally is a qualified production activity under the conference agreement, does not include activities carried out at retail establishment. Thus, under the conference agreement while the gross receipts of a meat packing establishment are qualified domestic production gross receipts, the activities of a master chef who creates a venison sausage for his or her restaurant menu cannot be construed as a qualified production activity.

water.[28] In addition, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[29]

The conferees recognize that some taxpayers may own facilities at which the predominant activity is domestic production as defined in the conference agreement and other facilities at which they engage in the retail sale of the taxpayer's produced goods and also sell food and beverages. For example, assume that the taxpayer buys coffee beans and roasts those beans at a facility, the primary activity of which is the roasting and packaging of roasted coffee. The taxpayer sells the roasted coffee through a variety of unrelated third-party vendors and also sells roasted coffee at the taxpayer's own retail establishments. In addition, at the taxpayer's retail establishments, the taxpayer prepares brewed coffee and other foods. The conferees intend that to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of its roasted coffee beans to customers, the receipts are qualified domestic production gross receipts, but to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of brewed coffee or food prepared at the retail establishment, the receipts are not qualified domestic production gross receipts. However, the conferees intend that, in this case, the taxpayer may allocate part of the receipts from the sale of the brewed coffee as qualified domestic production gross receipts to the extent of the value of the roasted coffee beans used to brew the coffee. The conferees intend that the Secretary provide guidance drawing on the principles of section 482 by which such a taxpayer can allocate gross receipts between qualified and nonqualified gross receipts. The conferees observe that in this example, the taxpayer's sales of roasted coffee beans to unrelated third parties would provide a value for the beans used in brewing a cup of coffee for retail sale.

The conferees intend that the disqualification of gross receipts derived from the sale of food and beverage prepared by the taxpayer at a retail establishment not be construed narrowly to apply only to establishments at which customers dine on premises. The receipts of a facility that prepares food and beverage solely for take out service would not be qualified production gross receipts. Likewise, the conferees intend that the disqualification of gross receipts derived from the sale of food and beverages prepared by the taxpayer need not be limited to retail establishments primarily engaged in the dining trade. For example, if a taxpayer operates a supermarket and as part of the supermarket the taxpayer operates an in-store bakery, the same allocation described above would apply to determine the extent to which the taxpayer's gross receipts represent qualified domestic production gross receipts.

[28] The conference agreement provides that domestic production gross receipts include the gross receipts from the production in the United States of electricity, gas, and potable water, but excludes the gross receipts from the transmission or distribution of electricity, gas, and potable water. Thus, in the case of a taxpayer who owns a facility for the production of electricity, whether the taxpayer's facility is part of a regulated utility or an independent power facility, the taxpayer's gross receipts from the production of electricity at that facility are qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users, any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of

electricity to final customers are not qualified domestic production gross receipts. For example, assume taxpayer A owns a wind turbine that generates electricity and taxpayer B owns a high-voltage transmission line that passes near taxpayer A's wind turbine and ends near the system of local distribution lines of taxpayer C. Taxpayer A sells the electricity produced at the wind turbine to taxpayer C and contracts with taxpayer B to transmit the electricity produced at the wind turbine to taxpayer C who sells the electricity to his or her customers using taxpayer C's distribution network. The gross receipts received by taxpayer A for the sale of electricity produced at the wind turbine constitute qualifying domestic production gross receipts. The gross receipts of taxpayer B from transporting taxpayer A's electricity to taxpayer C are not qualifying domestic production gross receipts. Likewise the gross receipts of taxpayer C from distributing the electricity are not qualifying domestic production gross receipts. Also, if taxpayer A made direct sales of electricity to customers in taxpayer C's service area and taxpayer C receives remuneration for the distribution of electricity, the gross receipts of taxpayer C are not qualifying domestic production gross receipts. If taxpayers A, B, and C are all related taxpayer, then taxpayers A, B, and C must allocate gross receipts to production activities, transmission activities, and distribution activities in a manner consistent with the preceding example.

The conference agreement provides that the same principles apply in the case of the natural gas and water supply industries. In the case of natural gas, production activities generally are all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. Such activities would produce qualifying domestic production gross receipts. However gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not qualified domestic production gross receipts. Likewise gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.

In the case of the production of potable water the conferees intend that activities involved in the production of potable water include the acquisition, collection, and storage of raw water (untreated water). It also includes the transportation of raw water to a water treatment facility and treatment of raw water at such a facility. However, any gross receipts from the storage of potable water after the water treatment facility or delivery of potable water to customers does not give rise to qualifying domestic production gross receipts. The conferees intend that a taxpayer that both produces potable water and distributes potable water will properly allocate gross receipts across qualifying and non-qualifying activities.

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

"Qualifying production property" generally includes any tangible personal property, computer software, or sound recordings. "Qualified film" includes any motion picture film or videotape[30] (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations[31]) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.[32]

Other rules

Qualified production activities income of passthrough entities (other than cooperatives)

With respect to domestic production activities of an S corporation, partnership, estate, trust or other passthrough entity (other than an agricultural or horticultural cooperative), although the wage limitation is applied first at the entity level, the deduction under the conference agreement generally is determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity. The Secretary is directed to prescribe rules for the application of the conference agreement to passthrough entities, including reporting requirements and rules relating to restrictions on the allocation of the deduction to taxpayers at the partner or similar level.

For purposes of applying the wage limitation at the level of a shareholder, partner, or similar person, each person who is allocated qualified production activities income from a passthrough entity also is treated as having been allocated wages from such entity in an amount that is equal to the lesser of: (1) such person's allocable share of wages, as determined under regulations prescribed by the Secretary; or (2) twice the appropriate deductible percentage of qualified production activities income that actually is allocated to such person for the taxable year.

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the conference agreement provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are

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[30] The conferees intend that the nature of the material on which properties described in section 168(f)(3) are embodied and the methods and means of distribution of such properties shall not affect their qualification under this provision.

[31] To the extent that a taxpayer has included an estimate of participations and/or residuals in its income forecast calculation under section 167(g), such taxpayer must use the same estimate of participations and/or residuals for purposes of determining total compensation.

[32] It is intended that the Secretary will provide appropriate rules governing the determination of total compensation for services performed in the United States.

manufactured, produced, grown, or extracted by cooperatives,[33] or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income).

In addition, the conference agreement provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the conference agreement, is deductible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income under section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

Alternative minimum tax

The deduction provided by the conference agreement is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Timber cutting

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

Exploration of fundamental tax reform

The conferees acknowledge that Congress has not reduced the statutory corporate income tax rate since 1986. According to the Organisation of Economic Cooperation and Development ("OECD"), the combined corporate income tax rate, as defined by the OECD, in most instances is lower than the U.S. corporate income tax rate.[34] Higher corporate tax rates factor into the United States' ability to attract and retain economically vibrant industries, which create good jobs and contribute to overall economic growth.

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[33] For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

[34] Organisation of Economic Cooperation and Development, Table 1.5, Tax Data Base Statistics, Tax Policy and Administration, Summary Tables (2003).

This legislation was crafted to repeal an export tax benefit that was deemed inconsistent with obligations of the United States under the Agreement on Subsidies and Countervailing Measures and other international trade agreements. This legislation replaces the benefit with tax relief specifically designed to be economically equivalent to a 3-percentage point reduction in U.S.-based manufacturing.

The conferees recognize that manufacturers are a segment of the economy that has faced significant challenges during the nation's recent economic slowdown. The conferees recognize that trading partners of the United States retain subsidies for domestic manufacturers and exports through their indirect tax systems. The conferees are concerned about the adverse competitive impact of these subsidies on U.S. manufacturers.

These concerns should be considered in the context of the benefits of a unified top tax rate for all corporate taxpayers, including manufacturing, in terms of efficiency and fairness. The conferees also expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.

Effective date.–The conference agreement is effective for taxable years beginning after December 31, 2004.

C. Reduced Corporate Income Tax Rate for Small Corporations (sec. 103 of the House bill and sec. 11 of the Code)

Present Law

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

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

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

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

House Bill

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

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

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

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

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

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

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

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

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

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

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

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

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

TITLE II – PROVISIONS RELATING TO JOB CREATION TAX INCENTIVES FOR MANUFACTURERS, SMALL BUSINESSES, AND FARMERS

A. Section 179 Expensing
(sec. 201 of the House bill, sec. 309 of the Senate amendment and sec. 179 of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[35] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[36] In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

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

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

Under present law, an expensing election is made under rules prescribed by the Secretary.[37] Applicable Treasury regulations provide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates.[38]

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[35] Pub. L. No. 108-27, sec. 202 (2003).

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

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

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an expensing election may be revoked only with consent of the Commissioner.[39] JGTRRA permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.[40]

House Bill

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

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

The provision provides that the $100,000 amount ($25,000 for taxable years beginning in 2006 and thereafter) is reduced (but not below zero) by only one half of the amount by which the

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[38] Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years ending after Jan. 25, 1993 (but not including property placed in service in taxable years beginning after 2002 and before 2006), a taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions).

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

[40] *Id.* Under Prop. and Temp. Treas. Reg. sec. 179-5T, applicable to property placed in service in taxable years beginning after 2002 and before 2006, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9146, Aug. 3, 2004.

cost of qualifying property placed in service during the taxable year exceeds $400,000 ($200,000 for taxable years beginning 2006 and thereafter).[41]

For example, under the provision, if in 2004 an eligible taxpayer places in service qualifying property costing $500,000, the $100,000 amount is reduced by $50,000 (i.e., one half the amount by which the $500,000 cost of qualifying property placed in service during the taxable year exceeds $400,000). Thus, the maximum amount eligible for section 179 expensing by this taxpayer for 2004 is $50,000.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement follows the House bill.

[41] As a result of the reduced phase-out percentage, the deductible amount in the New York Liberty Zone, an enterprise zone or a renewal community is correspondingly increased. See sec. 1400L(f), sec. 1397A and sec. 1400J.

B. Depreciation

1. Recovery period for depreciation of certain leasehold improvements (sec. 211 of the House bill and sec. 168 of the Code)

Present Law

In general

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

Depreciation of leasehold improvements

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[42] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[43] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service.[44]

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[42] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

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

[44] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component"

Qualified leasehold improvement property

The Job Creation and Worker Assistance Act of 2002[45] ("JCWAA"), as amended by JGTRRA, generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Treatment of dispositions of leasehold improvements

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

House Bill

The House bill provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006.[46] The provision requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction,[47] with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such

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of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). *See, e.g., Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

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

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

[47] Sec. 168(k).

improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Effective date.–The House bill provision is effective for property placed in service after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

2. Recovery period for depreciation of certain restaurant improvements (sec. 211 of the House bill and sec. 168 of the Code)

Present Law

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

House Bill

The House bill provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.[48] For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The provision requires that qualified restaurant property be recovered using the straight-line method.

Effective date.–The House bill provision is effective for property placed in service after the date of enactment.

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

3. Extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry) (sec. 212 of the House bill, sec. 622 of the Senate amendment, and sec. 168 of the Code)

Present Law

In general

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

Thirty-percent additional first year depreciation deduction

JCWAA allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[49] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[50] The basis of the property and the depreciation allowances in the placed-in-service year and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are generally no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is

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

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

allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.[51]

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[52] Second, the original use[53] of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must acquire the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005.

An extension of the placed-in-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[54] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005.[55] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001. For property eligible for the extended placed-in-service date, a special rule limits the

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

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

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

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

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

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

amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2005 ("progress expenditures") is eligible for the additional first-year depreciation.[56]

Fifty-percent additional first year depreciation

JGTRRA provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. Property eligible for the 50-percent additional first-year depreciation deduction is not eligible for the 30-percent additional first-year depreciation deduction.

In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005, and no binding written contract for the acquisition can be in effect before May 6, 2003.[57] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed-in-service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2005 are eligible for the additional first-year depreciation.[58]

House Bill

Due to the extended production period, the House bill provides criteria under which certain non-commercial aircraft can qualify for the extended placed-in-service date. Qualifying aircraft are eligible for the additional first-year depreciation deduction if placed in service before January 1, 2006. In order to qualify, the aircraft must:

(1) be acquired by the taxpayer during the applicable time period as under present law;

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

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

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

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

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

(4) be purchased[59] by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of ten percent of the cost or $100,000; and

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

Effective date.–The House bill provision is effective as if included in the amendments made by section 101 of JCWAA, which applies to property placed in service after September 10, 2001. However, because the property described by the provision qualifies for the additional first-year depreciation deduction under present law if placed in service prior to January 1, 2005, the provision will modify the treatment only of property placed in service during calendar year 2005.

Senate Amendment

The Senate amendment is the same as the House bill, except for the effective date.

Effective date.–The Senate amendment is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the House bill.

4. Special placed in service rule for bonus depreciation for certain property subject to syndication (sec. 213 of the House bill, sec. 621 of the Senate amendment, and sec. 168 of the Code)

Present Law

Section 101 of JCWAA provides generally for 30-percent additional first-year depreciation, and provides a binding contract rule in determining property that qualifies for it. The requirements that must be satisfied in order for property to qualify include that (1) the original use of the property must commence with the taxpayer on or after September 11, 2001, and (2) the taxpayer must acquire the property (i) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (ii) pursuant to a binding contract which was entered into after September 10, 2001, and before January 1, 2005. In addition, JCWAA provides a special rule in the case of certain leased

[59] For this purpose, it is intended that the term "purchase" be interpreted as it is defined in sec. 179(d)(2).

property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. JCWAA did not specifically address the syndication of a lease by the lessor.

The Working Families Tax Relief Act of 2004 ("H.R. 1308") included a technical correction regarding the syndication of a lease by the lessor. The technical correction provides that if property is originally placed in service by a lessor (including by operation of the special rule for self-constructed property), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

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

House Bill[60]

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

Effective date.–The House bill provision is generally effective as if included in the amendments made by section 101 of JCWAA (i.e., generally for property placed in service after September 10, 2001, in taxable years ending after that date). However, the special rule in the case of multiple units of property subject to the same lease applies to property sold after June 4, 2004.

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[60] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of technical corrections.

Senate Amendment[61]

The Senate amendment is the same as the House bill, except for the effective date.

Effective date.–The Senate amendment is effective for sales occurring after the date of enactment.

Conference Agreement

The conference agreement follows the House bill with the following modification. The clauses that were duplicative of the provisions enacted as part of H.R. 1308 were removed. Thus, the conference agreement provision provides only for the special rule in the case of multiple units of property subject to the same lease.

[61] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of technical corrections.

C. S Corporation Reform and Simplification (secs. 221-231 of the House bill, sec. 654 of the Senate amendment and secs. 1361-1379 and 4975 of the Code)

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

1. Members of family treated as one shareholder

Present Law

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[62] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, or a Domestic International Sales Corporation ("DISC") or former DISC.

House Bill

The bill provides an election to allow all members of a family be treated as one shareholder in determining the number of shareholders in the corporation (for purposes of section 1361(b)(1)(A)).

A family is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. An individual shall not be a common ancestor if, as of the later of the time of the election or the effective date of this provision, the individual is more than three generations removed from the youngest generation of

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

shareholders who would (but for this rule) be members of the family. For purposes of this rule, a spouse or former spouse is treated as in the same generation as the person to whom the individual is (or was) married.

Except as provided by Treasury regulations, the election for a family may be made by any family member and remains in effect until terminated.

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill, except that the number of generations is increased from three to six.

The conferees wish to clarify that members of a family may be treated as one shareholder, for the purpose of determining the number of shareholders, whether a family member holds stock directly or is treated as a shareholder (under section 1361(c)(2)(B)) by reason being a beneficiary of an electing small business trust or qualified subchapter S trust.

2. Increase in number of eligible shareholders to 100

Present Law

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[63] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, or a Domestic International Sales Corporation ("DISC") or former DISC.

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

3. Expansion of bank S corporation eligible shareholders to include IRAs

Present Law

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

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

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

House Bill

The bill allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment of the provision.[64]

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

Effective date.–The provision takes effect on date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

4. Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT

Present Law

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

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

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[64] Under the bill, the present-law rules treating S corporation stock held by a qualified retirement plan (other than an employee stock ownership plan) or a charity as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank.

House Bill

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

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

5. Transfers of suspended losses incident to divorce, etc.

Present Law

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

House Bill

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

Effective date.–The provision applies to transfers after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

6. Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries

Present Law

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

7. Exclusion of investment securities income from passive investment income test for bank S corporations

Present Law

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.[65]

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

House Bill

The bill provides that, in the case of a bank (as defined in section 581), a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act), interest income and dividends on assets required to be held by the bank or holding company are not treated as passive investment income for purposes of the S corporation passive investment income rules.

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

8. Treatment of bank director shares

Present Law

An S corporation may have no more than 75 shareholders and may have only one outstanding class of stock.[66]

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.[67]

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[65] Notice 97-5, 1997-1 C.B. 352, sets forth guidance relating to passive investment income on banking assets.

[66] Another provision of the bill increases the maximum number of shareholders to 100.

[67] Sec. 1361(c)(4). Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price

National banking law requires that a director of a national bank own stock in the bank and that a bank have at least five directors.[68] A number of States have similar requirements for State-chartered banks. Apparently, it is common practice for a bank director to enter into an agreement under which the bank (or a holding company) will reacquire the stock upon the director's ceasing to hold the office of director, at the price paid by the director for the stock.[69]

House Bill

Under the bill, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S. Thus, the stock is not treated as a second class of stock; a director is not treated as a shareholder of the S corporation by reason of the stock; the stock is disregarded in allocating items of income, loss, etc. among the shareholders; and the stock is not treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

Restricted bank director stock is stock in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act), registered with the Federal Reserve System, if the stock is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation for the taxable year that includes the last day of the director's taxable year in which the distribution is included in income.

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

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that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361-1(l).

[68] 12 U.S.C. secs. 71-72.

[69] See Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

The conference agreement does not include the provision in the House bill.

9. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations

Present Law

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill, effective for elections and terminations after December 31, 2004.

10. Information returns for qualified subchapter S subsidiaries

Present Law

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the provision in the House bill.

11. Repayment of loans for qualifying employer securities

Present Law

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

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[70] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property between a plan and a disqualified person, (2) the lending of money or other extension of credit between a plan and a disqualified person, and (3) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.[71] In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer securities held by the ESOP are used to repay the loan. The employer securities are held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[72] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

[70] Sec. 4975.

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

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

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[73] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.[74]

Effective for taxable years beginning after December 31, 1997, a qualified retirement plan (including an ESOP) may be a shareholder of an S corporation.[75] As a result, an S corporation may maintain an ESOP.

House Bill

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

Effective date.–The provision is effective for distributions made with respect to S corporation stock after December 31, 2004.

Senate Amendment

The Senate amendment is the same as House bill (other than the effective date).

Effective date.–The provision is effective on January 1, 1998.

Conference Agreement

The conference agreement contains the provision in the House bill and Senate amendment, with a modification of the effective date. Thus, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution

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

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

[75] Sec. 1361(c)(6).

made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

Effective date.–The provision is effective for distributions made with respect to S corporation stock after December 31, 1997.

D. Alternative Minimum Tax Relief

1. Repeal limitation on use of foreign tax credit (sec. 241 of the House bill, sec. 203 of the Senate amendment, and sec. 59 of the Code)

Present Law

In general

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

Foreign tax credit

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

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

Senate Amendment

Same as House bill.

Conference Agreement

The conference agreement includes the provision in the House bill and Senate amendment.

2. Expansion of exemption from alternative minimum tax for small corporations (sec. 242 of the House bill and sec. 55 of the Code)

Present Law

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

House Bill

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

Effective date.–The provision applies to taxable years beginning after December 31, 2005.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the provision in the House bill.

3. Coordinate farmer and fisherman income averaging and the alternative minimum tax (sec. 243 of the House bill and secs. 55 and 1301 of the Code)

Present Law

An individual taxpayer engaged in a farming business (as defined by section 263A(e)(4)) may elect to compute his or her current year regular tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. Because farmer income averaging reduces the regular tax liability, the AMT may be increased. Thus, the benefits of farmer income averaging may be reduced or eliminated for farmers subject to the AMT.

House Bill

The House bill provides that, in computing AMT, a farmer's regular tax liability is determined without regard to farmer income averaging. Thus, a farmer receives the full benefit of income averaging because averaging reduces the regular tax while the AMT (if any) remains unchanged.

Effective date.–The provision applies to taxable years applies to taxable years beginning after December 31, 2003.

Senate Amendment

No provision.

Conference Agreement

The conference agreement extends the benefits of income averaging to fishermen. The provision also includes the provision in the House bill relating to the AMT, applicable to both farmers and fishermen.

Effective date.–Taxable years beginning after December 31, 2003.

E. Restructuring of Incentives for Alcohol Fuels, Etc.

1. Incentives for alcohol and biodiesel fuels (secs. 251 and 252 of the House bill, sec. 861 of the Senate amendment, and secs. 4041, 4081, 4091, 6427, 9503 and new section 6426 of the Code)

Present Law

Alcohol fuels income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2007.[76]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[77]) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline (or of alcohol and a special fuel) sold by the blender as fuel or used as fuel by the blender in producing the mixture. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.[78]

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

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

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

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

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

Excise tax reductions for alcohol mixture fuels

In general

Generally, motor fuels tax rates are as follows:[79]

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

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

Gasohol

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

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2004, the following reduced rates apply to gasohol:[80]

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

Reduced excise tax rates also apply when gasoline is purchased for the production of "gasohol." When gasoline is purchased for blending into gasohol, the rates above are multiplied

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

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

by a fraction (e.g., 10/9 for 10-percent gasohol) so that the increased volume of motor fuel will be subject to tax. The reduced tax rates apply if the person liable for the tax is registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or entering the gasoline or (2) gasoline is sold upon its removal or entry and such person has an unexpired certificate from the buyer and has no reason to believe the certificate is false.[81]

Qualified methanol and ethanol fuels

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.[82] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2004 is 13.15 cents. From January 1, 2005, through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.

Alcohol produced from natural gas

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.[83] For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other cases, the rate is 11.4 cents per gallon. After September 30, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

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

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

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

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

21.333 cents per gallon for 2004 and 21.444 cents per gallon for the period January 1, 2005, through September 30, 2007.[84]

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

Aviation fuel

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.[85] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[86] In the case of 10 percent ethanol mixtures, for any sale or use during 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007. [87]

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

Refunds and payments

If fully taxed gasoline (or other taxable fuel) is used to produce a qualified alcohol mixture, the Code permits the blender to file a claim for a quick excise tax refund. The refund is equal to the difference between the gasoline (or other taxable fuel) excise tax that was paid and the tax that would have been paid by a registered blender on the alcohol fuel mixture being produced. Generally, the IRS pays these quick refunds within 20 days. Interest accrues if the refund is paid more than 20 days after filing. A claim may be filed by any person with respect to gasoline, diesel fuel, or kerosene used to produce a qualified alcohol fuel mixture for any period for which $200 or more is payable and which is not less than one week.

Ethyl tertiary butyl ether (ETBE)

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

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

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

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

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

fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

Highway Trust Fund

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per gallon of the tax imposed is retained in the General Fund.[88] In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.[89]

Biodiesel

If biodiesel is used in the production of blended taxable fuel, the Code imposes tax on the removal or sale of the blended taxable fuel.[90] In addition, the Code imposes tax on any liquid other than gasoline sold for use or used as a fuel in a diesel-powered highway vehicle or diesel-powered train unless tax was previously imposed and not refunded or credited.[91] If biodiesel that was not previously taxed or exempt is sold for use or used as a fuel in a diesel-powered highway vehicle or a diesel-powered train, tax is imposed.[92] There are no reduced excise tax rates for biodiesel.

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

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels, as well as small-engine fuel taxes,

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

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

[90] Sec. 4081(b); Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002). "Taxable fuels" are gasoline, diesel and kerosene (sec. 4083). Biodiesel, although suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train, contains less than four percent normal paraffins and, therefore, is not treated as diesel fuel under the applicable Treasury regulations. Treas. Reg. secs. 48.4081-1(c)(2)(i) and (ii), and 48.4081-1(b); Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002). As a result, biodiesel alone is not a taxable fuel for purposes of section 4081. As noted above, however, tax is imposed upon the removal or entry of blended taxable fuel made with biodiesel.

[91] Sec. 4041. The tax imposed under section 4041 also will not apply if an exemption from tax applies.

[92] Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002).

that are first deposited into the Highway Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions.[93]

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, the Code currently transfers 13.5 cents per gallon from the Highway Trust Fund to the Aquatics Resources Trust Fund and Land and Water Conservation Fund. The remainder, 4.8 cents per gallon, is retained in the General Fund. In addition, the Sport Fish Restoration Account of the Aquatics Resources Trust Fund receives 13.5 cents per gallon of the revenues from the tax imposed on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. The balance of 4.8 cents per gallon is retained in the General Fund.[94]

House Bill

Overview

The provision eliminates reduced rates of excise tax for alcohol-blended fuels and imposes the full rate of excise tax on alcohol-blended fuels (18.4 cents per gallon on gasoline blends and 24.4 cents per gallon of diesel blended fuel). In place of reduced rates, the provision permits the section 40 alcohol mixture credit, with certain modifications, to be applied against excise tax liability. The credit may be taken against the tax imposed on taxable fuels (by section 4081). To the extent a person does not have section 4081 liability, the provision allows taxpayers to file a claim for payment equal to the amount of the credit for the alcohol used to produce an eligible mixture. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit is claimed with respect to alcohol used in the production of any alcohol mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The provision eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund.

Alcohol fuel mixture excise tax credit and payment provisions

Alcohol fuel mixture excise tax credit

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

In lieu of the reduced excise tax rates, the provision provides that the alcohol mixture credit provided under section 40 may be applied against section 4081 excise tax liability (hereinafter referred to as "the alcohol fuel mixture credit"). The credit is treated as a payment

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

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

of the taxpayer's tax liability received at the time of the taxable event. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. The credit declines to 51 cents per gallon after calendar year 2004. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon. As discussed further below, the excise tax credit is refundable in order to provide a benefit equivalent to the reduced tax rates, which are being repealed under the provision.

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

<u>Payments with respect to qualified alcohol fuel mixtures</u>

To the extent the alcohol fuel mixture credit exceeds any section 4081 liability of a person, the Secretary is to pay such person an amount equal to the alcohol fuel mixture credit with respect to such mixture. These payments are intended to provide an equivalent benefit to replace the partial exemption for fuels to be blended with alcohol and alcohol fuels being repealed by the provision. If claims for payment are not paid within 45 days, the claim is to be paid with interest. The provision also provides that in the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest. If claims are filed electronically, the claimant may make a claim for less than $200.

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

<u>Alcohol fuel subsidies borne by General Fund</u>

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

<u>Motorboat and small engine fuel taxes</u>

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

Effective dates

The provisions generally are effective for fuel sold or used after September 30, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon of tax regarding alcohol fuels is effective for taxes imposed after September 30, 2003. The repeal of the 4.8 cents per gallon General Fund retention of the taxes imposed on fuels used in motorboats and small engine equipment is effective for taxes imposed after September 30, 2006. The provision regarding the crediting of the full amount of tax to the Highway Trust Fund without regard to credits and payments is effective for taxes received after September 30, 2004, and payments made after September 30, 2004.

Senate Amendment

Alcohol fuels

The Senate amendment is similar to the House bill with respect to alcohol fuels, except that it also provides that outlay payments are available for neat alcohol used as fuel. In addition, the Senate amendment also extends the alcohol fuels income tax credit (sec. 40) through December 31, 2010. The Senate amendment requires importers and producers of alcohol to be registered with the Secretary. Finally, the provision extends the temporary additional duty on ethanol through January 1, 2011.

Biodiesel fuels

The Senate amendment creates a refundable excise tax credit for biodiesel fuel mixtures similar to that created for alcohol fuel mixtures. The excise tax credit for biodiesel mixtures is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel (determined without regard to any use of kerosene) that is (1) sold for use or used by the taxpayer producing such mixture as a fuel, or (2) removed from the refinery by a person producing the mixture. In the case of agri-biodiesel, the credit is $1.00 per gallon. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product. The Senate amendment also provides for outlay payments for biodiesel, not in a mixture, used as a fuel.

The credit is not available for any sale or use for any period after December 31, 2006. Credits and outlay payments are paid out of the General Fund, rather than the Highway Trust Fund. The excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

The Senate amendment requires importers and producers of biodiesel to be registered with the Secretary.

Motorboat and small engine fuel taxes

The Senate amendment does not change the General Fund's retention of the 4.8 cents per gallon imposed on motorboat and small engine fuel.

Effective date

The provisions generally are effective for fuel sold or used after September 30, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon regarding alcohol fuels is effective for fuel sold or used after September 30, 2003. The Secretary is to provide electronic filing instructions by September 30, 2004. The extension of the section 40 alcohol fuels credit is effective on the date of enactment. The requirement that producers and importers of alcohol and biodiesel be registered is effective April 1, 2005.

Conference Agreement

Overview

The conference agreement generally follows the Senate amendment. The conference agreement does not include outlay payments for neat alcohol and 100 percent biodiesel fuels. The conference agreement does not change the temporary duty on ethanol. In addition, the conference agreement does not change the General Fund's retention of the 4.8 cents per gallon imposed on motorboat and small engine fuel.

The conference agreement eliminates reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on most alcohol-blended fuels (18.3 cents per gallon on gasoline blends and 24.3 cents per gallon of diesel blended fuel). In place of reduced rates, the conference agreement creates two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit. The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). The conference agreement allows taxpayers to file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture.

Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit or biodiesel fuel mixture credit is claimed with respect to alcohol or biodiesel used in the production of any alcohol or biodiesel mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit.

The conference agreement eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund. The Highway Trust Fund is credited with the full amount of tax imposed on alcohol and biodiesel fuel mixtures.

The conference agreement also extends the present-law alcohol fuels income tax credit through December 31, 2010.

Alcohol fuel mixture excise tax credit

The provision eliminates the reduced rates of excise tax for most alcohol-blended fuels.[95] Under the provision, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture.

In lieu of the reduced excise tax rates, the provision provides for an excise tax credit, the alcohol fuel mixture credit. The alcohol fuel mixture credit is 51 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon.

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and a taxable fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Taxable fuel is gasoline, diesel, and kerosene.[96] A mixture that includes ETBE or other ethers produced from alcohol produced by any person at a refinery prior to a taxable event is treated as sold at the time of its removal from the refinery (and only at such time) to another person for use as a fuel.

The excise tax credit is coordinated with the alcohol fuels income tax credit and is available through December 31, 2010.

Biodiesel mixture excise tax credit

The provision provides an excise tax credit for biodiesel mixtures.[97] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. In the case of agri-biodiesel, the credit is $1.00 per gallon. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

[95] The provision does not change the present-law treatment of fuels blended with alcohol derived from natural gas (under sec. 4041(m)), or alcohol derived from coal or peat (under sec. 4041(b)(2)). The provision does not change the taxes imposed to fund the Leaking Underground Storage Tank Trust Fund.

[96] Sec. 4083(a)(1). Under present law, dyed fuels are taxable fuels that have been exempted from tax.

[97] The excise tax credit uses the same definitions as the biodiesel fuels income tax credit.

The credit is not available for any sale or use for any period after December 31, 2006. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments with respect to qualified alcohol and biodiesel fuel mixtures

To the extent the alcohol fuel mixture credit exceeds any section 4081 liability of a person, the Secretary is to pay such person an amount equal to the alcohol fuel mixture credit with respect to such mixture. Thus, if the person has no section 4081 liability, the credit is totally refundable. These payments are intended to provide an equivalent benefit to replace the partial exemption for fuels to be blended with alcohol and alcohol fuels being repealed by the provision. Similar rules apply to the biodiesel fuel mixture credit.

If claims for payment are not paid within 45 days, the claim is to be paid with interest. The provision also provides that in the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest. If claims are filed electronically, the claimant may make a claim for less than $200. The Secretary is to describe the electronic format for filing claims by December 31, 2004.

The payment provision does not apply with respect to alcohol fuel mixtures sold after December 31, 2010, and biodiesel fuel mixtures sold after December 31, 2006.

Alcohol and biodiesel fuel subsidies borne by General Fund

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

Registration requirement

Every person producing or importing biodiesel or alcohol is required to register with the Secretary.

Alcohol fuels income tax credit

The provision extends the alcohol fuels credit (sec. 40) through December 31, 2010.

Effective dates

The provisions generally are effective for fuel sold or used after December 31, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon regarding alcohol fuels is effective for fuel sold or used after September 30, 2004. The Secretary is to provide electronic filing instructions by December 31, 2004. The registration requirement is effective April 1, 2005.

2. Biodiesel income tax credit (sec. 862 of the bill and new sec. 40A of the Code)

<u>Present Law</u>

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. Registered blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with alcohol. These present law provisions are scheduled to expire in 2007.

<u>House Bill</u>

No provision.

<u>Senate Amendment</u>

<u>In general</u>

The Senate amendment provides a new income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed above. The credit may not be carried back to a taxable year ending before or on September 30, 2004. The provision does not apply to fuel sold or used after December 31, 2006.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel which identifies the product produced and the percentage of the biodiesel and agri-biodiesel in the product.

<u>Biodiesel mixture credit</u>

The biodiesel mixture credit is 50 cents for each gallon of biodiesel used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of 100 percent biodiesel which is not in a mixture with diesel fuel and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is $1.00 per gallon.

Later separation or failure to use as fuel

In a manner similar to the treatment of alcohol fuels, a tax is imposed if a biodiesel fuels credit is claimed with respect to biodiesel that is subsequently used for a purpose for which the credit is not allowed or that is changed into a substance that does not qualify for the credit.

Effective date

The biodiesel fuel income tax credit provision is effective for fuel produced, and sold or used after September 30, 2004, in taxable years ending after such date.

Conference Agreement

The conference agreement generally follows the Senate amendment, except for the effective date.

Effective date.–The provision is effective for fuel produced, and sold or used after December 31, 2004, in taxable years ending after such date

F. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options from Wages (sec. 261 of the House bill and secs. 421(b), 423(c), 3121(a), 3231, and 3306(b) of the Code)

Present Law

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[98]

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

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[99] The applicable Code provisions[100] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option.

There has been uncertainty in the past as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[101]

House Bill

The House bill provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the House bill, FICA and FUTA taxes do not apply upon the exercise of a statutory stock

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

[99] Secs. 3101, 3111 and 3301.

[100] Secs. 3121 and 3306.

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

option.[102] The House bill also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

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

Effective date.–The House bill is effective for stock acquired pursuant to options exercised after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

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

G. Incentives to Reinvest Foreign Earnings in the United States (sec. 271 of the House bill, sec. 231 of the Senate amendment, and new sec. 965 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, under anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral provisions in this context are the controlled foreign corporation rules of subpart F[103] and the passive foreign investment company rules.[104] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.[105]

House Bill

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

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

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[103] Secs. 951-964.

[104] Secs. 1291-1298.

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

The deduction is subject to a number of limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before March 31, 2003, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such five years (the "base-period average"). In addition to actual dividends, deemed repatriations under section 956 and distributions of earnings previously taxed under subpart F are included in the base-period average.

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

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

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

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

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

Senate Amendment

Under the provision, certain actual and deemed dividends received by a U.S. corporation from a controlled foreign corporation are subject to tax at a reduced rate of 5.25 percent. For corporations taxed at the top corporate income tax rate of 35 percent, this rate reduction is equivalent to an 85-percent dividends-received deduction. This rate reduction is available only for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment of the provision.

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[106] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

In order to qualify for the reduced rate, dividends must be described in a "domestic reinvestment plan" approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States, "including as a source for the funding of worker hiring and training; infrastructure; research and development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation."

The provision disallows 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and removes 85 percent of the underlying income from the taxpayer's foreign tax credit limitation fraction under section 904. In addition, any expenses, losses, or deductions of the taxpayer may not be used to reduce the tax on dividends qualifying for the benefits of the provision.

In the case of an affiliated group, an election under the provision is made by the common parent on a group-wide basis, and all members of the group are treated as a single taxpayer. The election applies to all controlled foreign corporations with respect to which an electing taxpayer is a United States shareholder.

Effective date.–The Senate amendment provision is effective for the first taxable year of an electing taxpayer ending 120 days or more after the provision's date of enactment.

Conference Agreement

The conference agreement follows the House bill, with modifications.

Under the conference agreement, certain dividends received by a U.S. corporation from controlled foreign corporations are eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either during the taxpayer's first taxable year beginning on or after the date of enactment of the bill, or during the taxpayer's last taxable year beginning before such date.[107] Dividends received after the election period will be taxed in the normal manner under present law. The conferees emphasize that this is a temporary economic stimulus measure, and that there is no intent to make this measure permanent, or to "extend" or enact it again in the future.

The deduction applies only to cash dividends and other cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304 (but

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[106] If the taxpayer has fewer than 5 taxable years ending on or before December 31, 2002, then the base period consists of all such taxable years, with none disregarded.

[107] The election is to be made on a timely filed return (including extensions) for the taxable year with respect to which the deduction is claimed.

not to amounts treated as dividends under Code sections 78, 367, or 1248).[108] The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956. Similarly, the deduction does not apply to distributions of earnings previously taxed under subpart F, except to the extent that the subpart F inclusions result from the payment of a dividend by one controlled foreign corporation to another controlled foreign corporation within a certain chain of ownership during the election period, with the result that cash travels through a chain of controlled foreign corporations to the taxpayer within the election period. The amount of dividends eligible for the deduction is reduced by any increase in related-party indebtedness on the part of a controlled foreign corporation between October 3, 2004 and the close of the taxable year for which the deduction is being claimed, determined by treating all controlled foreign corporations with respect to which the taxpayer is a U.S. shareholder as one controlled foreign corporation.[109] This rule is intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (e.g., through a related party) finances the payment of a dividend from a controlled foreign corporation. In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.

The deduction is subject to a number of general limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before June 30, 2003, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such five years (the "base-period average"). If the taxpayer has fewer than five such years, then all taxable years ending on or before June 30, 2003 are included in the base period.[110] Repatriation levels are determined by reference to base-period tax returns as filed, including any amended returns that were filed on or before June 30, 2003. U.S. shareholders that file a consolidated tax return are treated as one U.S. shareholder for all purposes of this dividends-received deduction provision. Thus, all such shareholders are aggregated in determining the base-period average (as are all controlled foreign corporations). In addition to cash dividends, dividends of property, deemed repatriations under

[108] However, to the extent that the taxpayer actually receives cash in an inbound liquidation that is described in Code section 332 and treated as a dividend under Code section 367(b), such amount is treated as a dividend for these purposes. The conferees note that a deemed liquidation effectuated by means of a "check the box" election under the entity classification regulations will not involve an actual receipt of cash that is reinvested in the United States as required for purposes of this provision.

[109] Thus, indebtedness between such controlled foreign corporations is disregarded for purposes of this determination.

[110] A corporation that was spun off from another corporation during the five-year period is treated for this purpose as having been in existence for the same period that such other corporation has been in existence. The pre-spin-off dividend history of the two corporations is generally allocated between them on the basis of their interests in the dividend-paying controlled foreign corporations immediately after the spin-off. In other cases involving companies entering and exiting corporate groups, the principles of Code section 41(f)(3)(A) and (B) apply.

section 956, and distributions of earnings previously taxed under subpart F are included in the base-period average.

Second, the amount of dividends eligible for the deduction is limited to the greatest of: (1) $500 million; (2) the amount of earnings shown as permanently invested outside the United States on the taxpayer's most recent audited financial statement which is certified on or before June 30, 2003;[111] or (3) in the case of an applicable financial statement that does not show a specific amount of such earnings, but that does show a specific amount of tax liability attributable to such earnings, the amount of such earnings determined by grossing up the tax liability at a 35-percent rate. If there is no applicable financial statement, or if such statement does not show a specific earnings or tax liability amount, then the $500 million limit applies. This $500 million amount is divided among corporations that are members of a controlled group, using a 50-percent standard of common control. The two financial statement amounts described above are divided among the U.S. shareholders that are included on such statements.

Third, in order to qualify for the deduction, dividends must be described in a domestic reinvestment plan approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation. The conferees note that this list of permitted uses is not exclusive. The reinvestment plan cannot, however, designate repatriated funds for use as payment for executive compensation. Dividends with respect to which the deduction is not being claimed are not required to be included in any domestic reinvestment plan.

No foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which dividends are not.[112] In other words, the taxpayer is allowed to choose which of its dividends are treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends are treated as comprising the excess eligible for the deduction (and thus entail proportional disallowance of any associated foreign tax credits). The deduction itself will have the effect of appropriately reducing the taxpayer's foreign tax credit limitation.

Deductions are disallowed for expenses that are properly allocated and apportioned to the deductible portion of any dividend.

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[111] This rule refers to elements of Accounting Principles Board Opinion 23 ("APB 23"), which provides an exception to the general rule of comprehensive recognition of deferred taxes for temporary book-tax differences. The exception is for temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint ventures that meet the indefinite reversal criterion in APB 23.

[112] In the absence of such a specification, a pro rata amount of foreign tax credits will be disallowed with respect to every dividend repatriated during the taxable year.

The income attributable to the nondeductible portion of a qualifying dividend may not be offset by expenses, losses, or deductions, and the tax attributable to such income generally may not be offset by credits (other than foreign tax credits and AMT credits).[113] The tax on this amount also cannot reduce the alternative minimum tax that otherwise would be owed by the taxpayer. However, the deduction available under this provision is not treated as a preference item for purposes of computing the AMT. Thus, the deduction is allowed in computing alternative minimum taxable income notwithstanding the fact that it may not be deductible in computing earnings and profits. No deduction under sections 243 or 245 is allowed for any dividend for which a deduction is allowed under the provision.

Effective date.–The provision is effective only for a taxpayer's first taxable year beginning on or after the date of enactment of the bill, or the taxpayer's last taxable year beginning before such date, at the taxpayer's election. The deduction available under the provision is not allowed for dividends received in any taxable year beginning one year or more after the date of enactment.

[113] These expenses, losses, and deductions may, however, have the effect of reducing other income of the taxpayer.

H. Other Incentive Provisions

1. Special rules for livestock sold on account of weather-related conditions (sec. 281 of the House bill, sec. 649 of the Senate amendment, and secs. 1033 and 451 of the Code)

Present Law

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

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the cost of such property reduced by the amount of gain not recognized.

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

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

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

House Bill

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

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

Senate Amendment

The Senate amendment is the same as the House bill, except that it also permits the taxpayer to replace compulsorily or involuntarily converted livestock with other farm property if, due to drought, flood, or other weather-related conditions, it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in use to the livestock so converted.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2001.

Conference Agreement

The conference agreement follows the Senate amendment, except for the effective date.

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

2. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 282 of the House bill, sec. 648 of the Senate amendment, and sec. 1388 of the Code)

Present Law

Under present law, cooperatives generally are entitled to deduct or exclude amounts distributed as patronage dividends in accordance with Subchapter T of the Code. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid and enforceable obligation to pay such amounts that was in existence before the cooperative received the amounts paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[114] The dividend allocation rule has been interpreted to require that such dividends be allocated between

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

a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

House Bill

The House bill provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income and do not prevent the cooperative from being treated as operating on a cooperative basis.

Effective date.–The House bill provision is effective for distributions made in taxable years ending after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Effective date.–The Senate amendment provision is effective for distributions made in taxable years ending after the date of enactment.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

3. Manufacturing relating to timber

a. Capital gains treatment to apply to outright sales of timber by landowner (sec. 283 of the House bill, sec. 333 of the Senate amendment, and sec. 631(b) of the Code)

Present Law

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

House Bill

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

Effective date.–The provision is effective for sales of timber after December 31, 2004.

Senate Amendment

The provision in the Senate amendment is the same as House bill.

Effective date.–The provision is effective for sales of timber after the date of enactment.

Conference Agreement

The conference agreement includes the provision in the House bill and Senate amendment.

Effective date.–The provision is effective for sales of timber after December 31, 2004.

b. Expensing of reforestation expenditures (sec. 331 of the Senate amendment and secs. 48 and 194 of the Code)

Present Law

Section 194 provides for an 84-month amortization period for up to $10,000 of qualified reforestation expenditures. Section 48(b) provides a 10-percent credit on up to $10,000 of qualified amortizable basis in timber property. The amount amortized under section 194 is reduced by one half of the amount of credit claimed under section 48(b).

House Bill

No provision.

Senate Amendment

The Senate amendment permits up to $10,000 of qualified reforestation expenditures to be deducted in the year paid or incurred (i.e., expensed). The Senate amendment permits qualified reforestation expenditures above $10,000 to be amortized over 84 months. The Senate amendment also repeals the reforestation tax credit.

Effective date.–Expenditures paid or incurred after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment provision.

c. Election to treat cutting of timber as a sale or exchange (sec. 102(b) of the House bill, sec. 332 of the Senate amendment, and sec. 631(a) of the Code)

Present Law

Under present law, a taxpayer may elect to treat the cutting of timber as a sale or exchange of the timber. If an election is made, the gain or loss is recognized in an amount equal to the difference between the fair market value of the timber and the basis of the timber. An election, once made, is effective for the taxable year and all subsequent taxable years, unless the IRS, upon a showing of undue hardship by the taxpayer, permits the revocation of the election. If an election is revoked, a new election may be made only with the consent of the IRS.

House Bill

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

Effective date.–The provision applies to taxable years ending after the date of enactment.

Senate Amendment

The provision is the same as the House bill, except the provision applies to all taxpayers.

Effective date.–The provision applies to taxable years ending after the date of enactment.

Conference Agreement

The conference agreement includes the provision in the Senate amendment.

d. Modified safe harbor rules for timber REITs (sec. 334 of the Senate amendment and sec. 857 of the Code)

Present Law

In general

Under present law, real estate investment trusts ("REITs") are subject to a special taxation regime. Under this regime, a REIT is allowed a deduction for dividends paid to its shareholders. As a result, REITs generally do not pay tax on distributed income. REITs are generally restricted to earning certain types of passive income, primarily rents from real property and interests on mortgages secured by real property.

To qualify as a REIT, a corporation must satisfy a number of requirements, among which are four tests: organizational structure, source of income, nature of assets, and distribution of income.

Income or loss from prohibited transactions

A 100-percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business,[115] other than foreclosure property.[116] A safe harbor is provided for certain sales of rent-producing real property. To qualify for the safe harbor, three criteria generally must be met. First, the REIT must have held the property for at least four years for rental purposes. Second, the aggregate expenditures made by the REIT during the four-year period prior to the date of the sale must not exceed 30 percent of the net selling price of the property. Third, either (i) the REIT must make seven or fewer sales of property during the taxable year or (ii) the aggregate adjusted basis of the property sold must not exceed 10 percent of the aggregate bases of all the REIT's assets at the beginning of the REIT's taxable year. In the latter case, substantially all of the marketing and development expenditures with respect to the property must be made through an independent contractor.

Certain timber income

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[117]

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than five percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[118]

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[115] Sec. 1221(a)(l)

[116] Thus, the 100-percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project.

[117] See, e.g., PLR 200052021, PLR 199945055, PLR 19927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

[118] Certain securities that are within a safe-harbor definition of "straight debt" are not taken into account for purposes of the limitation to no more than 10 percent of the value of an issuer's outstanding securities.

Special rules for taxable REIT subsidiaries

Under an exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a REIT[119] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass-through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[120]

House Bill

No provision.

Senate Amendment

Under the provision, a sale of a real estate asset by a REIT will not be a prohibited transaction if the following six requirements are met:

(1) The asset must have been held for at least four years in the trade or business of producing timber;

(2) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property (other than timberland acquisition expenditures[121]) and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;

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

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

[121] The timberland acquisition expenditures that are excluded for this purpose are those expenditures that are related to timberland other than the specific timberland that is being sold under the safe harbor, but costs of which may be combined with costs of such property in the same "management block" under Treas. Reg. sec. 1.611-3(d). Any specific timberland being sold must meet the requirement that it has been held for at least four years by the REIT in order to qualify for the safe harbor.

(3) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property and that are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland must not exceed five percent of the net selling price of the property;

(4) The REIT either (a) does not make more than seven sales of property (other than sales of foreclosure property or sales to which 1033 applies) or (b) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property sold during the year (other than sales of foreclosure property or sales to which 1033 applies) does not exceed 10 percent of the aggregate bases (as determined for purposes of computing earnings and profits) of property of all assets of the REIT as of the beginning of the year;

(5) Substantially all of the marketing expenditures with respect to the property are made by persons who are independent contractors (as defined by section 856(d)(3)) with respect to the REIT and from whom the REIT does not derive any income; and

(6) The sales price on the sale of the property cannot be based in whole or in part on income or profits of any person, including income or profits derived from the sale of such properties.

Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (i.e., silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods, grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); (2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4) nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; and (7) initial stand fertilization, up through stand establishment. Other examples of capital expenditures incurred directly in the operation of raising timber include construction cost of road to be used for managing the timber land (including for removal of logs or fire protection), environmental costs (i.e., habitat conservation plans), and any other post stand establishment capital costs (e.g., “mid-term fertilization costs).”

Capital expenditures counted towards the five-percent limit are those capital expenditures incurred in the ownership of undeveloped land that are not incurred in the direct operation of raising timber (i.e., silviculture). This category of capital expenditures includes: (1) expenditures to separate the REIT's holdings of land into separate parcels; (2) costs of granting leases or easements to cable, cellular or similar companies; (3) costs in determining the presence or quality of minerals located on the land; (4) costs incurred to defend changes in law that would limit future use of the land by the REIT or a purchaser from the REIT; (5) costs incurred to determine alternative uses of the land (e.g., recreational use); and (6) development costs of the property incurred by the REIT (e.g., engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber).

Costs that are not includible in the basis of the property are not counted towards either the 30-percent or five-percent requirements.

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

Conference Agreement

The conference agreement follows the Senate amendment.

4. Net income from publicly traded partnerships treated as qualifying income of regulated investment company (sec. 284 of the House bill, sec. 899 of the Senate amendment, and secs. 851(b), 469(k), 7704(d) and new sec. 851(h) of the Code)

Present Law

Treatment of RICs

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. In computing its taxable income, a RIC deducts dividends paid to its shareholders to achieve conduit treatment.[122] In order to qualify for conduit treatment, a RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act.[123] In addition, the corporation must elect RIC status, and must satisfy certain other requirements.[124]

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

[122] Sec. 852(b).

[123] Sec. 851(a).

[124] Sec. 851(b).

respect to its business of investing in such stock, securities, or currencies.[125] Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the "look-through" rule for partnership income).[126] Under present law, no distinction is made under this rule between a publicly traded partnership and any other partnership.

The RIC qualification rules include limitations on the ownership of assets and on the composition of the RIC's assets.[127] Under the ownership limitation, at least 50 percent of the value of the RIC's total assets must be represented by cash, government securities and securities of other RICs, and other securities; however, in the case of such other securities, the RIC may invest no more than five percent of the value of the total assets of the RIC in the securities of any one issuer, and may hold no more than 10 percent of the outstanding voting securities of any one issuer. Under the limitation on the composition of the RIC's assets, no more than 25 percent of the value of the RIC's total assets may be invested in the securities of any one issuer (other than Government securities), or in securities of two or more controlled issuers in the same or similar trades or businesses. These limitations generally are applied at the end of each quarter.[128]

<u>Treatment of publicly traded partnerships</u>

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation, but an exception to corporate treatment is provided if 90 percent or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income.[129]

A special rule for publicly traded partnerships applies under the passive loss rules. The passive loss rules limit deductions and credits from passive trade or business activities.[130] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. The special rule for publicly traded partnerships provides that the passive loss rules are applied

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[125] Sec. 851(b)(2).

[126] Sec. 851(b).

[127] Sec. 851(b)(3).

[128] Sec. 851(d).

[129] Sec. 7704(a), (c), and (d).

[130] Sec. 469.

separately with respect to items attributable to each publicly traded partnership.[131] Thus, income or loss from the publicly traded partnership is treated as separate from income or loss from other passive activities.

House Bill

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

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

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

Effective date.–The House bill provision is effective for taxable years beginning after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and Senate amendment. In addition, the conference agreement provides that net income from an interest in a publicly traded partnership is used for purposes of both the numerator and denominator of the 90-percent test. As under present law, the conference agreement also provides that gains from the sale or other disposition of interests in publicly traded partnerships constitute qualifying income of regulated investment companies.

5. Improvements related to real estate investment trusts (sec. 285 of the House bill and secs. 856, 857 and 860 of the Code)

Present Law

In general

Real estate investment trusts ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for

[131] Sec. 469(k).

dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

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

Organizational structure requirements

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

Income requirements

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

Qualified rental income

Amounts received as impermissible “tenant services income” are not treated as rents from real property.[132] In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property.[133]

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT

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

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

owns, directly or indirectly, 10 percent or more of the vote or value.[134] An exception applies to rents received from a taxable REIT subsidiary ("TRS") (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[135]

Certain hedging instruments

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

Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-percent income tests but has set out the income it did receive in a schedule and any error in the schedule is not due to fraud with intent to evade tax, then the REIT does not lose its REIT status provided that the failure to meet the 95-percent or 75-percent test is due to reasonable cause and not due to willful neglect. If the REIT qualifies for this relief, the REIT must pay a tax measured by the greater of the amount by which 90 percent [136] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[137]

Asset requirements

75-percent asset test

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

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

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

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

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

Limitation on investment in other entities

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

"Straight debt" exception

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S)[138] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if: (1) the issuer is an individual; (2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt; or (3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt for purposes of the REIT provision [139] is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and (ii) there is no convertibility (directly or indirectly) into stock.

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

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

Special rules for taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a real estate investment trust[140] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income

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

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

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

tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass-through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents to the extent that the amount of the rents would be reduced on distribution, apportionment, or allocation under section 482 to clearly reflect income as a result of services furnished by a TRS of the REIT to a tenant of the REIT.[141]

The 100 percent excise tax does not apply to amounts received directly or indirectly by a REIT from a TRS that would be excluded from unrelated taxable income if received by an organization described in section 511(a)(2). Such amounts are defined in section 512(b)(3).

Rents paid by a TRS to a REIT generally are treated as rents from real property if at least 90 percent of the leased space of the property is rented to persons other than the REIT's TRSs and other than persons related to the REIT. In such a case, the rent paid by the TRS to the REIT is treated as rent from real property only to the extent that it is substantially comparable to rents from other tenants of the REIT's property for comparable space. .

Income distribution requirements

A REIT is generally required to distribute 90 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. If a REIT declares certain dividends after the end of its taxable year but before the time prescribed for filing its return for that year and distributes those amounts to shareholders within the 12 months following the close of that taxable year, such distributions are treated as made during such taxable year for this purpose. As described further below, a REIT can also make certain "deficiency dividends" after the close of the taxable year after a determination that it has not distributed the correct amount for qualification as a REIT.

Consequences of failure to meet requirements

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

If a REIT fails to meet the source of income requirements, but has set out the income it did receive in a schedule and any error in the schedule is not due to fraud with intent to evade tax, then the REIT does not lose its REIT status, provided that the failure to meet the 95-percent

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

or 75-percent test is due to reasonable cause and not to willful neglect. If the REIT qualifies for this relief, the REIT must pay the disallowed income as a tax to the Treasury.[142]

Failure to satisfy the asset test is excused if the REIT eliminates the discrepancy within 30 days. Failure to meet distribution requirements may also be excused if the REIT was unable to meet such requirement by reason of distributions previously made to meet the requirements of section 4981.

There are no similar provisions that allow a REIT to pay a penalty and avoid disqualification in the case of other qualification failures.

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

House Bill

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

Straight debt modification

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

Straight debt securities

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

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

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

aggregate face amount of the debt instruments held by the REIT exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

Also, the time or amount of any payment is permitted to be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary commercial practice.[143]

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

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

Other securities

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

Safe harbor testing date for certain rents

The provision provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are

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

provided solely for purposes of the special provision permitting rents received from a TRS to be treated as qualified rental income for purposes of the income tests.[144]

Customary services exception

The provision prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[145] or are from a TRS and are described in section 512(b)(3). Instead, such payments are free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

Hedging rules

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce certain interest rate risks are prospectively generally conformed to the rules included in section 1221. Also, the defined income of a REIT from such a hedging transaction is excluded from gross income for purposes of the 95-percent of gross income requirement.

95-percent of gross income requirement

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

Consequences of failure to meet REIT requirements

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

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

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a REIT may not hold securities possessing more than 10 percent of the total voting power or 10

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

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

percent of the total value of the outstanding securities of any one issuer.[146] The requirements must be satisfied each quarter.

The provision provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) one percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[147]

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

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

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

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

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

The provision conforms the reporting and reasonable cause standards for failure to meet the income tests to the new asset test standards. However, the provision does not change the rule under section 857(b)(5) that for income test failures, all of the net income attributed to the disqualified gross income is paid as tax.

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

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

Other failures

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

Taxes and penalties paid deducted from amount required to be distributed

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

Expansion of deficiency dividend procedure

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

Effective date

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

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

6. Treatment of certain dividends of regulated investment companies (sec. 286 of the House bill and secs. 871 and 881 of the Code)

Present Law

Regulated investment companies

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

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

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

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

U.S. source investment income of foreign persons

In general

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

<u>Interest</u>

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

<u>Capital gains</u>

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

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

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[148] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

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

House Bill

In general

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

Interest-related dividends

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

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

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

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

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

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

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

Short-term capital gain dividends

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

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

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

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

Estate tax treatment

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

Effective date

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except the conference agreement only applies: (1) to dividends with respect to taxable years of RICs beginning after December 31, 2004 and before January 1, 2008; (2) with respect to the treatment of a RIC for estate tax purposes, to estates of decedents dying after December 31, 2004 and before January 1, 2008; and (3) with respect to the treatment of RICs under section 897 (relating to U.S. real property interests), after December 31, 2004 and before January 1, 2008.

7. Taxation of certain settlement funds (sec. 287 of the House bill and sec. 468B of the Code)

Present Law

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

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

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

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

House Bill

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

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

8. Expand human clinical trials expenses qualifying for the orphan drug tax credit (sec. 288 of the House bill and sec. 45C of the Code)

Present Law

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

House Bill

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

Effective date.–The provision is effective for expenditures paid or incurred after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

9. Simplification of excise tax imposed on bows and arrows (sec. 289 of the House bill, sec. 305 of the Senate amendment, and sec. 4161 of the Code)

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.[149] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[150] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[151]

House Bill

The provision increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[152] The provision also imposes an excise tax of 12

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

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

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

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

percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the bill. In the case of any arrow comprised of a shaft or any other component upon which tax has been imposed, the amount of the arrow tax is equal to the excess of (1) the arrow tax that would have been imposed but for this exception, over (2) the amount of tax paid with respect to such components.[153] Finally, the provision subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective date.–The provision is effective for articles sold by the manufacturer, producer or importer after December 31, 2004.

Senate Amendment

The Senate amendment is the same as the House bill.

Effective date.–The provision is effective for articles sold by the manufacturer, producer or importer 30 days after the date of enactment.

Conference Agreement

The conference agreement follows the House bill and Senate amendment with the effective date of the Senate amendment.

Effective date.–The conference agreement follows the Senate amendment.

10. Reduce rate of excise tax on fishing tackle boxes to three percent (sec. 290 of the House bill and sec. 4162 of the Code)

Present Law

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

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

House Bill

The provision repeals the excise tax on fishing tackle boxes.

Effective date.–The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with modifications. Under the provision as modified, the rate of excise tax imposed on fishing tackle boxes is reduced to three percent.

11. Repeal of excise tax on sonar devices suitable for finding fish (sec. 291 of the House bill and secs. 4161 and 4162 of the Code)

Present Law

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[154] A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.[155] Further, the tax imposed on the sale of sonar devices suitable for finding fish is limited to $30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.[156]

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

House Bill

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

Effective date.–The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

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

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

[156] Sec. 4162(b).

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

12. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories (sec. 292 of the House bill)

Present Law

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

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

House Bill

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

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

The credit only applies to domestically bottled distilled spirits[157] purchased directly from the bottler of such spirits. The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

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

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

Effective date.–The provision is effective for taxable years beginning after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

13. Suspension of occupational taxes relating to distilled spirits, wine, and beer (sec. 293 of the House bill and new sec. 5148 of the Code)

Present Law

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

Producers:[158]	
Distilled spirits and wines (sec. 5081)	$1,000 per year, per premise
Brewers (sec. 5091)	$1,000 per year, per premise
Wholesale dealers (sec. 5111):	
Liquors, wines, or beer	$500 per year
Retail dealers (sec. 5121):	
Liquors, wines, or beer	$250 per year
Nonbeverage use of distilled spirits (sec. 5131):	$500 per year
Industrial use of distilled spirits (sec. 5276):	$250 per year

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.[159] A delegate of the Secretary of the Treasury is authorized to

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

[159] Secs. 5114, 5124.

inspect the records of any dealer during business hours.[160] There are penalties for failing to comply with the recordkeeping requirements.[161]

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

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

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

(3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[162]

In addition, a limited retail dealer (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in liquors.[163]

Violation of this restriction is punishable by $1,000 fine, imprisonment of one year, or both.[164] A violation also makes the alcohol subject to seizure and forfeiture.[165]

House Bill

Under the provision, the special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2004 through June 30, 2007. Present law recordkeeping and registration requirements continue to apply, notwithstanding the suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements, except that a limited retail dealer may purchase distilled spirits for resale from a retail dealer in liquors, as permitted under present law.

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[160] Sec. 5146.

[161] Sec. 5603.

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

[163] Sec. 5117(b).

[164] Sec. 5687.

[165] Sec. 7302.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill except as follows. Under the provision as modified, the three-year suspension period is July 1, 2005 through June 30, 2008.

14. Modification of unrelated business income limitation on investment in certain small business investment companies (sec. 294 of the House bill, sec. 642 of the Senate amendment, and sec. 514 of the Code)

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes. Certain types of income, such as rents, royalties, dividends, and interest, generally are excluded from unrelated business taxable income except when such income is derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed income-producing property. An exempt organization's share of partnership income that is derived from such debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

House Bill

The House bill modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act, and (2) held or guaranteed by the Small Business Administration. The exclusion shall not apply during any period that any exempt organization (other than a governmental unit) owns more than 25 percent of the capital or profits interest in the small business investment company, or exempt organizations (including governmental units other than any agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in such company.

Effective date.–The provision is effective for small business investment companies formed after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill except that the Senate amendment does not contain any individual or aggregate ownership percentage limitations with respect to exempt organizations or government units.

Effective date.–The provision is effective for acquisitions made on or after the date of enactment.

Conference Agreement

The conference agreement follows the House bill, modified to apply to small business investment companies licensed after (rather than formed after) the date of enactment.

Effective date.--The conference agreement provision is effective for debt incurred after the date of enactment by small business investment companies licensed after the date of enactment.

15. Election to determine taxable income from certain international shipping activities using per ton rate (sec. 295 of the House bill and new secs. 1352-1359 of the Code)

Present Law

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

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is "effectively connected" with the conduct of a trade or business in the United States (sec. 882). Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a four percent tax on the amount of a foreign corporation's U.S. gross transportation income (sec. 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in earning the income, and (2) substantially all the income is attributable to regularly scheduled transportation.

The taxes imposed by section 882 and 887 on income from shipping operations may be limited by an applicable U.S. income tax treaty or by an exemption of a foreign corporation's international shipping operations income in instances where a foreign country grants an equivalent exemption (sec. 883).

Under present law, there is no provision that provides an alternative to the corporate income tax for taxable income attributable to international shipping activities.

House Bill

In general

The provision generally allows corporations to elect a "tonnage tax" on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax. Accordingly, a corporation's income from qualifying shipping activities is no longer taxable under sections 11, 55, 882, 887 or 1201(a) under the regime, and electing entities are only subject to tax at the maximum corporate income tax rate on a notional amount based on the net tonnage of a corporation's qualifying vessels. However, a foreign corporation is not subject to tax under the tonnage tax regime to the extent its income from qualifying shipping activities is subject to an exclusion for certain shipping operations by foreign corporations pursuant to section 883(a)(1) or pursuant to a treaty obligation of the United States.

Taxable income from qualifying shipping activities

Generally, the taxable income of an electing corporation from qualifying shipping activities is the corporate income percentage[166] of the sum of the taxable income from each of its qualifying vessels. The taxable income from each qualifying vessel is the product of (1) the

[166] The "corporate income percentage" is the least aggregate share, expressed as a percentage, of any item of income or gain of an electing corporation, or an electing group (i.e., a controlled group of which one or more members is an electing entity) of which such corporation is a member from qualifying shipping activities that would otherwise be required to be reported on the U.S. Federal income tax return of an electing corporation during any taxable period. A "controlled group" is any group of trusts and business entities whose members would be treated as a single employer under the rules of section 52(a) (without regard to paragraphs (1) and (2)) and section 52(b)(1)).

daily notional taxable income[167] from the operation of the qualifying vessel in United States foreign trade,[168] and (2) the number of days during the taxable year that the electing entity operated such vessel as a qualifying vessel in U.S. foreign trade.[169] A "qualifying vessel" is described as a self-propelled U.S.-flag vessel of not less than 10,000 deadweight tons used in U.S. foreign trade.

An entity's qualifying shipping activities consist of its (1) core qualifying activities, (2) qualifying secondary activities, and (3) qualifying incidental activities. Generally, core qualifying activities are activities from operating vessels in U.S. foreign trade and other activities of an electing entity and an electing group that are an integral part of the business of operating qualifying vessels in U.S. foreign trade. Qualifying secondary activities generally consist of the active management or operation of vessels in U.S. foreign trade and provisions for vessel, container and cargo-related facilities or such other activities as may be prescribed by the Secretary (which are not core activities), and may not exceed 20 percent of the aggregate gross income derived from electing entities and other members of its electing group from their core qualifying activities. Qualifying incidental activities are activities that are incidental to core qualifying activities and are not qualifying secondary activities. The aggregate gross income from qualifying incidental activities cannot exceed one-tenth of one percent of the aggregate gross income from the core qualifying activities of the electing entities and other members of its electing group.

Items not subject to corporate income tax

Generally, gross income from an electing entity does not include the corporate income percentage of an entity's (1) income from qualifying shipping activities in U.S. foreign trade, (2) income from money, bank deposits and other temporary investments which are reasonably necessary to meet the working capital requirements of its qualifying shipping activities, and (3) income from money or other intangible assets accumulated pursuant to a plan to purchase qualifying shipping assets.[170] Generally, the corporate loss percentage[171] of each item of loss,

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[167] The "daily notional taxable income" from the operation of a qualifying vessel is 40 cents for each 100 tons of the net tonnage of the vessel (up to 25,000 net tons), and 20 cents for each 100 tons of the net tonnage of the vessel, in excess of 25,000 net tons.

[168] "U.S. foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. As a general rule, the temporary operation in the U.S. domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel is disregarded. However, a vessel that is no longer used for operations in U.S. foreign trade (unless such non-use is on a temporary basis) ceases to be a qualifying vessel when such non-use begins.

[169] If there are multiple operators of a vessel, the taxable income of such vessel must be allocated among such persons on the basis of their ownership and charter interests or another basis that Treasury may prescribe in regulations.

[170] "Qualifying shipping assets" means any qualifying vessel and other assets which are used in core qualifying activities.

deduction, or credit is disallowed with respect to any activity the income from which is excluded from gross income under the provision. The corporate loss percentage of an electing entity's interest expense is disallowed in the ratio that the fair market value of its qualifying shipping assets bears to the fair market value of its total assets.

Allocation of credits, income, and deductions

No deductions are allowed against the taxable income of an electing corporation from qualifying shipping activities, and no credit is allowed against the tax imposed under the tonnage tax regime. No deduction is allowed for any net operating loss attributable to the qualifying shipping activities of a corporation to the extent that such loss is carried forward by the corporation from a taxable year preceding the first taxable year for which such corporation was an electing corporation. For purposes of the provision, section 482 applies to a transaction or series of transactions between an electing entity and another person or between an entity's qualifying shipping activities and other activities carried on by it. The qualifying shipping activities of an electing entity shall be treated as a separate trade or business activity from all other activities conducted by the entity.

Qualifying shipping assets

If an electing entity sells or disposes of qualifying shipping assets in an otherwise taxable transaction, at the election of the entity no gain is recognized if replacement qualifying shipping assets are acquired during a limited replacement period except to the extent that the amount realized upon such sale or disposition exceeds the cost of the replacement qualifying shipping assets. In the case of replacement qualifying shipping assets purchased by an electing entity which results in the nonrecognition of any part of the gain realized as the result of a sale or other disposition of qualifying shipping assets, the basis is the cost of such replacement property decreased in the amount of gain not recognized. If the property purchased consists of more than one piece of property, the basis is allocated to the purchased properties in proportion to their respective costs.

The election not to recognize gain on the disposition and replacement of qualifying shipping assets is not available if the replacement qualifying shipping assets are acquired from a related person except to the extent that the related person (as defined under section 267(b) or 707(b)(1)) acquired the replacement qualifying shipping assets from an unrelated person during a limited replacement period.

Election

Generally, any qualifying entity may elect into the tonnage tax regime by filing an election with the qualifying entity's income tax return for the first taxable year to which the

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[171] "Corporate loss percentage" means the greatest aggregate share, expressed as a percentage, of any item of loss, deduction or credit of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would otherwise be required to be reported on the U.S. Federal income tax return of an electing corporation during any taxable period.

election applies. However, a qualifying entity, which is a member of a controlled group, may only make an election into the tonnage tax regime if all qualifying entities that are members of the controlled group make such an election. Once made, an election is effective for the taxable year in which it was made and for all succeeding taxable years of the entity until the election is terminated. An election may be terminated if the entity ceases to be a qualifying entity or if the election is revoked. In the event that a qualifying entity elects into the tonnage tax regime and subsequently revokes the election, such entity is barred from electing back into the regime until the fifth taxable year after the termination is effective, unless the Secretary of the Treasury consents to the election.

A qualifying entity means a trust or business entity that (1) operates one or more qualifying vessels and (2) meets the "shipping activity requirement."[172] The shipping activity requirement is met for a taxable year only by an entity that meets one of the following requirements: (1) in the first taxable year of its election into the tonnage tax regime, for the preceding taxable year on average at least 25 percent of the aggregate tonnage of the qualifying vessels which were operated by the entity were owned by the entity or bareboat chartered to the entity; (2) in the second or any subsequent taxable year of its election into the tonnage tax regime, in each of the two preceding taxable years on average at least 25 percent of the aggregate tonnage of the qualifying vessels which were operated by the entity were owned by the entity or bareboat chartered to the entity; or (3) requirements (1) or (2) above would be met if the 25 percent average tonnage requirement was applied on an aggregate basis to the controlled group of which such entity is a member, and vessel charters between members of the controlled group were disregarded.

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with modifications.

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[172] An entity is generally treated as operating any vessel owned by or chartered to the entity. However, an entity is treated as operating a vessel that it has chartered out on bareboat basis only if: (1) the vessel is temporarily surplus to the entity's requirements and the term of the charter does not exceed three years or (2) the vessel is bareboat chartered to a member of a controlled group which includes such entity or to an unrelated third party that sub-bareboats or time charters the vessel to a member of such controlled group (including the owner). Special rules apply in an instance in which an electing entity temporarily ceases to operate a qualifying vessel.

In general

The proposal generally allows corporations to elect a "tonnage tax" in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities, and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels. An electing corporation is treated as a separate trade or business activity distinct from all other activities conducted by such corporation.

Notional shipping income

An electing corporation's notional shipping income for the taxable year is the sum of the following amounts for each of the qualifying vessels it operates: (1) the daily notional shipping income[173] from the operation of the qualifying vessel in United States foreign trade,[174] and (2) the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in United States foreign trade.[175] However, in the case of a qualifying vessel any of the income of which is not included in gross income, the amount of notional shipping income from such vessel is equal to the notional shipping income from such vessel (determined without regard to this provision) that bears the same ratio as the gross income from the operation of such vessel in the United States foreign trade bears to the sum of such gross income and the income so excluded. Generally, a "qualifying vessel" is described as a self-propelled U.S.-flag vessel of not less than 10,000 deadweight tons used exclusively in U.S. foreign trade.

Items not subject to corporate income tax

Generally, a corporate member of an electing group[176] does not include in gross income its income from qualifying shipping activities. Qualifying shipping activities consist of (1) core qualifying activities, (2) qualifying secondary activities, and (3) qualifying incidental activities. All of an electing entity's core qualifying activities are excluded from gross income. However, only a portion of an electing corporation's secondary and incidental activities are treated as qualifying income and thus, are excluded from gross income.

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[173] The daily notional shipping income from the operation of a qualifying vessel is 40 cents for each 100 tons of the net tonnage of the vessel (up to 25,000 net tons), and 20 cents for each 100 tons of the net tonnage of the vessel, in excess of 25,000 net tons.

[174] "United States foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. The temporary use in the United States domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel is deemed to be the use in the United States foreign trade of such vessel, if such use does not exceed 30 days in a taxable year.

[175] Special rules apply in the case of multiple operators of a vessel.

[176] An electing group means any group that would be treated as a single employer under subsection (a) or (b) of section 52 if paragraphs (1) and (2) of section 52(a) did not apply.

Core qualifying activities consist of the operation of qualifying vessels.[177] Secondary activities generally consist of (1) the active management or operation of vessels in U.S. foreign trade; (2) the provision of vessels, barge, container or cargo-related facilities or services; and (3) other activities of the electing corporation and other members of its electing group that are an integral part of its business of operating qualifying vessels in United States foreign trade. Secondary activities do not include any core qualifying activities. In addition, any activities that would otherwise constitute core qualifying activities of a corporation, who is a member of an electing group but is not an electing corporation, are treated as qualifying secondary activities. Incidental activities are activities that are incidental to core qualifying activities and are not qualifying secondary activities.

Denial of credits, income and deductions

Each item of loss, deduction, or credit of any taxpayer is disallowed with respect to the income that is excluded from gross income under the proposal. An electing corporation's interest expense is disallowed in the ratio that the fair market value of its qualifying vessels bears to the fair market value of its total assets; special rules apply for disallowing interest expense in the context of an electing group.

No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. No deduction is allowed for any net operating loss attributable to the qualifying shipping activities of a corporation to the extent that such loss is carried forward by the corporation from a taxable year preceding the first taxable year for which such corporation was an electing corporation.

Dispositions of qualifying vessels

Generally, if an qualifying vessel operator sells or disposes of a qualifying vessel in an otherwise taxable transaction, at the election of the operator no gain is recognized if a replacement qualifying vessel is acquired during a limited replacement period except to the extent that the amount realized upon such sale or disposition exceeds the cost of the replacement qualifying vessels. Generally, in the case of the replacement of a qualifying vessel that results in the nonrecognition of any part of the gain under the rule above, the basis of the replacement vessel is the cost of such replacement property decreased in the amount of gain not recognized.

Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.[178]

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[177] It is intended that the operation of a lighter-aboard-ship be treated as the operation of a vessel and not the operation of a barge.

[178] A person is generally treated as operating and using any vessel owned by or chartered to it and that is used as a qualifying vessel during such period. Special rules apply in the case of pass-through entities, and special rules apply in an instance in which an electing entity temporarily ceases to operate a qualifying vessel due to dry-docking, surveying, inspection, repairs and the like.

Special rules apply in determining whether corporate partners in pass-through entities are treated as qualifying vessel operators.

Election

Generally, any qualifying vessel operator may elect into the tonnage tax regime and such election is made in the form prescribed by Treasury. An election is only effective if made before the due date (including extensions) for filing the corporation's return for such taxable year. However, a qualifying vessel operator, which is a member of a controlled group, may only make an election into the tonnage tax regime if all qualifying vessel operators that are members of the controlled group make such an election. Once made, an election is effective for the taxable year in which it was made and for all succeeding taxable years of the entity until the election is terminated.

Effective date

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

16. Charitable contribution deduction for certain expenses in support of Native Alaskan subsistence whaling (sec. 296 of the House bill and sec. 170 of the Code)

Present Law

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

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution.[179] Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

House Bill

The House bill allows individuals to claim a deduction under section 170 not exceeding $10,000 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction is available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction is available for reasonable and necessary expenses paid by the taxpayer during the taxable year for: (1) the

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[179] Treas. Reg. sec. 1.170A-1(g).

acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities; (2) the supplying of food for the crew and other provisions for carrying out such activities; and (3) the storage and distribution of the catch from such activities. It is intended that the Secretary shall require that the taxpayer substantiate deductible expenses by maintaining appropriate written records that show, for example, the time, place, date, amount, and nature of the expense, as well as the taxpayer's eligibility for the deduction, and that such substantiation be provided as part of the taxpayer's income tax return, to the extent provided by the Secretary.

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

Effective date.–The provision is effective for contributions made after December 31, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the House bill provision, modified to provide that the Secretary shall issue guidance regarding substantiation of amounts claimed as deductible whaling expenses.

I. General Provisions

1. Modification to qualified small issue bonds (sec. 301 of the Senate amendment and sec. 144 of the Code)

Present Law

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the maximum allowable amount of total capital expenditures by an eligible business or a related party in the same municipality or county during the six-year measurement period from $10 million to $20 million. As under present law, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other present-law limits (e.g., the $40 million per borrower limit) continue to apply.

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

Conference Agreement

The conference agreement follows the Senate amendment, except with respect to the effective date. The conference agreement increases the maximum allowable amount of total capital expenditures by an eligible business (or related party) in the same municipality or county from $10 million to $20 million for bonds issued after September 30, 2009.

Effective date.–The provision is effective for bonds issued after September 30, 2009.

2. Expensing of investment in broadband equipment (sec. 302 of the Senate amendment and new sec. 191 of the Code)

Present Law

Under present law, a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS) of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Revenue Procedure 87-56.[180]

House Bill

No provision.

Senate Amendment

The Senate amendment provides that the taxpayer may elect to treat qualified broadband expenditures paid or incurred during the one-year period beginning after the date of enactment as a deduction in the taxable year in which the equipment is placed in service.

Qualified expenditures are expenditures incurred with respect to equipment with which the taxpayer offers current generation broadband services to qualified subscribers. In addition, qualified expenditures include qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers next generation broadband services to qualified subscribers. Current generation broadband services are defined as the transmission of signals at a rate of at least 1 million bits per second to the subscriber and at a rate of at least 128,000 bits per second from the subscriber. Next generation broadband services are defined as the transmission of signals at a rate of at least 22 million bits per second to the subscriber and at a rate of at least 5 million bits per second from the subscriber.

Qualified subscribers for the purposes of the current generation broadband deduction include nonresidential subscribers in rural or underserved areas, and residential subscribers in

[180] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

rural or underserved areas that are not in a saturated market. A saturated market is defined as a census tract in which current generation broadband services have been provided by a single provider to 85 percent or more of the total number of potential residential subscribers residing within such census tracts. For the purposes of the next generation broadband deduction, qualified subscribers include nonresidential subscribers in rural or underserved areas or any residential subscriber. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment would be capable of serving.

Qualifying equipment must be capable of providing broadband services a majority of the time during periods of maximum demand. Qualifying equipment is equipment that extends from (1) the last point of switching to the outside of the building in which the subscriber is located, (2) the customer side of a mobile telephone switching office to a transmission/reception antenna (including the antenna) of the subscriber, (3) the customer side of the headend to the outside of the building in which the subscriber is located, or (4) a transmission/reception antenna to a transmission/reception antenna on the outside of the building used by the subscriber. Any packet switching equipment deployed in connection with other qualifying equipment is qualifying equipment, regardless of location, provided that it is the last such equipment in a series as part of transmission of a signal to a subscriber or the first in a series in the transmission of a signal from a subscriber. Also, multiplexing and demultiplexing equipment are qualified equipment.

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

<u>Effective date</u>.–The provision is effective for expenditures incurred after the date of enactment.

<u>Conference Agreement</u>

The conference agreement does not include the Senate amendment provision.

3. Exemption for natural aging process from interest capitalization (sec. 303 of the Senate amendment and sec. 263A of the Code)

<u>Present Law</u>

Section 263A provides uniform rules for capitalization of certain costs. In general, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs of real or tangible personal property produced by a taxpayer or real or personal property that is acquired by a taxpayer for resale. Costs attributable to producing or acquiring property generally must be capitalized by charging such costs to basis or, in the case of property which is inventory in the hands of the taxpayer, by including such costs in inventory.

Special rules apply for the allocation of interest expense to property produced by the taxpayer.[181] In general, interest paid or incurred during the production period of certain types of property that is allocable to the production of the property must be capitalized. Property subject to the interest capitalization requirement includes property produced by the taxpayer for use in its trade or business or in an activity for profit, but only if it (1) is real property, (2) has an estimated production period exceeding two years (one year if the cost of the property exceeds $1 million), or (3) has a class life of 20 years or more (as defined under section 168). The production period of property for this purpose begins when construction or production is commenced and ends when the property is ready to be placed in service or is ready to be held for sale. For example, in the case of property such as tobacco, wine, or whiskey that is aged before it is sold, the production period includes the aging period. Activities such as planning or design generally do not cause the production period to begin.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that for purposes of determining the production period for purposes of capitalization of interest expense under section 263A(f) that the production period for distilled spirits shall be determined without regard to any period allocated to the natural aging process.[182]

Effective date.–The Senate amendment applies to production periods beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[181] Sec. 263A(f).

[182] It is intended that, for purposes of the provision, the natural aging process begin when the distilled spirits are placed in charred barrels to lie for an extended period of time to allow such product to obtain its color, much of its distinctive flavor, and to mellow. The natural aging process concludes when the distilled spirits are removed from the barrel.

4. Section 355 "active business test" applied to chains of affiliated corporations (sec. 304 of the Senate amendment and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[183] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[184]

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[185] However, if the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[186]

House Bill

No provision.

Senate Amendment

Under the bill, the active business test is determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)), immediately after the

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[183] Section 355(b).

[184] Section 355(b)(2)(A).

[185] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[186] Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

Effective date.–The bill applies to distributions after the date of enactment, with three exceptions. The bill does not apply to distributions (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The bill also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[187]

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Modification to cooperative marketing rules to include value-added processing involving animals (sec. 306 of the Senate amendment and sec. 1388 of the Code)

Present Law

Under present law, cooperatives generally are treated similarly to pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Farmers' cooperatives are tax-exempt and include cooperatives of farmers, fruit growers, and like organizations that are organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and remitting the proceeds of sales, less necessary marketing expenses, on the basis of either the quantity or the value of products furnished by them (sec. 521). Farmers' cooperatives may claim a limited amount of additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

In determining whether a cooperative qualifies as a tax-exempt farmers' cooperative, the IRS has apparently taken the position that a cooperative is not marketing certain products of members or other producers if the cooperative adds value through the use of animals (e.g., farmers sell corn to a cooperative which is fed to chickens that produce eggs sold by the cooperative).

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[187] For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off prior to the date of enactment, in which spin-off the taxpayer satisfied the “substantially all” active business stock test of present law section 355(b)(2)(A) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurs after the date of enactment and that would satisfy the requirements of new section 355(b)(2)(A).

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

6. Extension of declaratory judgment procedures to farmers' cooperative organizations (sec. 307 of the Senate amendment and sec. 7428 of the Code)

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[188] In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

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

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[188] For disputes involving the initial or continuing qualification of an organization described in sections 501(c)(3), 509(a), or 4942(j)(3), declaratory judgment actions may be brought in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. For all other Federal tax declaratory judgment actions, proceedings may be brought only in the U.S. Tax Court.

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment provision is effective for pleadings filed after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

7. Temporary suspension of personal holding company tax (sec. 308 of the Senate amendment and sec. 541 of the Code)

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Table 1.–Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0 - $50,000	15 percent of taxable income
$50,001 - $75,000	25 percent of taxable income
$75,001 - $10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333.

When a corporation distributes its after-tax earnings to individual shareholders as dividends, a tax is imposed on the shareholders at rates up to 15 percent.[189] If a corporation

[189] The 15-percent rate applies to dividends received in taxable years beginning before January 1, 2009. Dividends received on or after that date are scheduled to be taxed at the rates applicable to ordinary income, which range up to 35 percent (39.6 percent for taxable years beginning after December 31, 2010).

receives a dividend from another corporation, the recipient corporation is entitled to a dividends-received deduction that excludes a significant part of the dividend from the recipient's income. The percentage of a dividend received that is deducted varies from 70 percent to 100 percent, depending on the level of ownership of the recipient corporation in the distributing corporation.[190] Thus, with a 70 percent dividends received deduction, the tax rate imposed on a dividend received by a corporation in the 35-percent tax bracket is 10.5 percent.[191] For corporations at lower rate brackets, the tax rates on these dividends are lower.

In addition to the regular corporate income tax, a corporate level penalty tax, the "personal holding company tax" is currently imposed at 15 percent [192] on certain corporate earnings of personal holding companies that are not distributed to shareholders. The personal holding company tax was originally enacted to prevent so-called "incorporated pocketbooks" that could be formed by individuals to hold assets that could have been held directly by the individuals, such as passive investment assets, and retain the income at corporate rates that were then significantly lower than individual tax rates.

Corporations are personal holding companies only if they are closely held and have substantial passive income. A corporation is closely held if, at any time during the last half of the taxable year, more than 50 percent of the value of the stock of the corporation is owned, directly or indirectly, by five or fewer individuals (determined with the application of specified attribution rules). A corporation has substantial passive income if at least 60 percent of the corporation's adjusted ordinary gross income (as defined for this purpose) is "personal holding company income," generally, income from interest, dividends, rents, royalties, compensation for use of corporate property by certain shareholders, and income under contracts giving someone other than the corporation the right to designate the individual service provider. Numerous adjustments apply in specified situations where there are specified indicia that the income is active rather than passive.

A corporation that otherwise would be subject to personal holding company tax can distribute, or can agree to be deemed to have distributed, its modified taxable income and avoid the tax. A corporation may make such an actual dividend distribution during its taxable year or, up to a specified limited amount, until the 15th day of the third month following the close of its taxable year. In addition, if an election is filed with its return for the year, its shareholders may agree to include a deemed amount in their income as if a dividend had been paid ("consent

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[190] If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns 80 percent or more of the distributing corporation, the dividends received deduction is generally 100 percent.

[191] This is the 35 percent tax rate, applied to the 30 percent of the dividend that is taxable after a 70 percent dividends-received deduction.

[192] This rate is scheduled to return to the highest individual tax rate when the lower dividend tax rate expires.

dividend"). A corporation may also make a "deficiency dividend" distribution within 90 days following a determination by the IRS or a court that personal holding company tax liability is due. That distribution can eliminate the personal holding company tax itself, though interest (and penalties, if any) with respect to such tax would still be owed to the IRS.[193]

House Bill

No provision.

Senate Amendment

The provision repeals the personal holding company tax until 2009, the period of time the 15 percent rate on dividends received by individuals is scheduled to be in effect.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

The provision would be treated, for purposes of section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 as enacted by Title III of that Act (relating to lower rates on capital gains and dividends), so that the provision terminates when those provisions terminate (currently scheduled to be for taxable years beginning after December 31, 2008).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. 5-year NOL carryback for 2003 NOLs if taxpayer elects out of bonus depreciation as modified; extend temporary suspension of 90-percent limit on minimum tax NOLs (sec. 310 of the Senate amendment and sec. 172 of the Code)

Present Law

In general, a net operating loss ("NOL") may be carried back two years and carried forward 20 years to offset taxable income in such years. The Job Creation and Worker Assistance Act of 2002 ("JCWAA") provides a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002.

The alternative minimum tax ("AMT") rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction). JCWAA also provides that an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, may offset 100 percent of a taxpayer's AMTI.

[193] Section 547.

JCWAA provides generally for an elective 30-percent additional first-year depreciation deduction. The requirements that must be satisfied in order for property to qualify include that (1) the original use of the property must commence with the taxpayer on or after September 11, 2001, (2) the taxpayer must acquire the property after September 10, 2001 and before September 11, 2004, and (3) no binding written contract for the acquisition of the property is in effect before September 11, 2001 (or, in the case of self-constructed property, manufacture, construction, or production of the property does not begin before September 11, 2001).

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") provides an elective additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. Property with respect to which the 50-percent additional first-year depreciation deduction is claimed is not also eligible for the 30-percent additional first-year depreciation deduction. In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the application of the five-year carryback period to NOLs arising in taxable years ending in 2003, provided that the taxpayer elects not to apply the bonus depreciation provisions of section 168(k). Under the provision, taxpayers with taxable years ending during January are permitted to apply the provision to tax years ending during January of 2004 rather than tax years ending during January of 2003. The provision also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2003, as well as NOL carryforwards to these taxable years, to offset 100 percent of a taxpayer's AMTI.

Effective date.–The Senate amendment applies to net operating losses for taxable years ending after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Manufacturer's jobs credit (sec. 313 of the Senate amendment)

Present Law

There is no present law credit for a manufacturer's employment of eligible Trade Adjustment Act ("TAA") recipients.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 50-percent tax credit for W-2 wages paid by the taxpayer to eligible TAA recipients (as defined in sec. 35(c)(2) of the Code). The credit may not exceed 50 percent of the lesser of: (1) the excess of the W–2 wages paid by the taxpayer during the taxable year over the W–2 wages paid by the taxpayer during the preceding taxable year, (2) the W–2 wages paid by the taxpayer during the taxable year to any employee who is an eligible TAA recipient for any month during such taxable year, or (3) 22.4 percent of the W–2 wages paid by the taxpayer during the taxable year. The amount of W–2 wages taken into account with respect to any employee for any taxable year shall not exceed $50,000.

The otherwise allowable credit is limited if the value of the taxpayer's non-domestic production increased from the preceding taxable year. In such case, the credit is (1) reduced to zero for taxpayers whose value of domestic production does not exceed that from the preceding taxable year, or (2) reduced by a percentage equal to the non-domestic share of the increase in the value of worldwide production from the preceding taxable year.

A taxpayer eligible for the credit is any taxpayer that has domestic production gross receipts for the taxable year and the preceding taxable year, and is not treated at any time during the taxable year as an inverted domestic corporation under section 7874 of the Senate amendment.

Effective date.–The provision applies to taxable years beginning after December 31, 2003, and before January 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment.

10. Brownfields demonstration program for qualified green building and sustainable design projects (sec. 314 of the Senate amendment and secs. 142 and 146 of the Code)

Present Law

In general

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

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. For example, interest on bonds issued to benefit section 501(c)(3) organizations is generally tax-exempt ("qualified 501(c)(3) bonds"). Both capital expenditures and limited working capital expenditures of section 501(c)(3) organizations may be financed with qualified 501(c)(3) bonds.

In addition, States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses.[194] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, hazardous waste disposal facilities, and public educational facilities); privately owned and/or operated low-income rental housing;[195] and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Generally, tax-exempt private activity bonds are subject to restrictions that do not apply to other bonds issued by State or local governments. For example, most tax-exempt private activity bonds are subject to annual volume limits on the aggregate face amount of such bonds that may be issued.[196]

House Bill

No provision.

Senate Amendment

In general

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[194] Secs. 141(e) and 142(a).

[195] Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

[196] Sec. 146.

The Senate amendment creates a new category of exempt-facility bond, the qualified green building and sustainable design project bond ("qualified green bond"). A qualified green bond is defined as any bond issued as part of an issue that finances a project designated by the Secretary, after consultation with the Administrator of the Environmental Protection Agency (the "Administrator") as a green building and sustainable design project that meets the following eligibility requirements: (1) at least 75 percent of the square footage of the commercial buildings that are part of the project is registered for the U.S. Green Building Council's LEED[197] certification and is reasonably expected (at the time of designation) to meet such certification; (2) the project includes a brownfield site;[198] (3) the project receives at least $5 million dollars in specific State or local resources; and (4) the project includes at least one million square feet of building or at least 20 acres of land.

Under the provision, qualified green bonds are not subject to the State bond volume limitations. Rather, there is a national limitation of $2 billion of qualified green bonds that the Secretary may allocate, in the aggregate, to qualified green building and sustainable design projects. Qualified green bonds may be currently refunded if certain conditions are met, but cannot be advance refunded. The authority to issue qualified green bonds terminates after September 30, 2009.

Application and designation process

The provision requires the submission of an application that meets certain requirements before a project may be designated for financing with qualified green bonds. In addition to the eligibility requirements listed above, each project application must demonstrate that the net benefit of the tax-exempt financing provided will be allocated for (i) the purchase, construction, integration or other use of energy efficiency, renewable energy and sustainable design features of the project, (ii) compliance with LEED certification standards, and/or (iii) the purchase, remediation, foundation construction, and preparation of the brownfield site. The application also must demonstrate that the project is expected, based on independent analysis, to provide the equivalent of at least 1,500 full-time permanent employees (150 full-time employees in rural States) when completed and the equivalent of at least 1,000 construction employees (100 full-

[197] The LEED ("Leadership in Energy and Environmental Design) Green Building Rating System is a voluntary, consensus-based national standard for developing high-performance sustainable buildings. Registration is the first step toward LEED certification. Actual certification requires that the applicant project satisfy a number of requirements. Commercial buildings, as defined by standard building codes are eligible for certification. Commercial occupancies include, but are not limited to, offices, retail and service establishments, institutional buildings (e.g. libraries, schools, museums, churches, etc.), hotels, and residential buildings of four or more habitable stories.

[198] For this purpose, a brownfield site is defined by section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601), including a site described in subparagraph (D)(ii)(II)(aa) thereof (relating to a site that is contaminated by petroleum or a petroleum product excluded from the definition of 'hazardous substance' under section 101).

time employees in rural States). In addition, each project application shall contain a description of: (1) the amount of electric consumption reduced as compared to conventional construction; (2) the amount of sulfur dioxide daily emissions reduced compared to coal generation; (3) the amount of gross installed capacity of the project's solar photovoltaic capacity measured in megawatts; and (4) the amount of the project's fuel cell energy generation, measured in megawatts.

Under the Senate Amendment, each project must be nominated by a State or local government within 180 days of enactment of this Act and such State or local government must provide written assurances that the project will satisfy certain eligibility requirements. Within 60 days after the end of the application period, the Secretary, after consultation with the Administrator, will designate the qualified green building and sustainable design projects eligible for financing with qualified green bonds. At least one of the projects must be in or within a ten-mile radius of an empowerment zone (as defined under section 1391 of the Code) and at least one project must be in a rural State.[199] No more than one project is permitted in a State. A project shall not be designated for financing with qualified green bonds if such project includes a stadium or arena for professional sports exhibitions or games.

The provision requires the Secretary, after consultation with the Administrator, to ensure that the projects designated shall, in the aggregate: (1) reduce electric consumption by more than 150 megawatts annually as compared to conventional construction; (2) reduce daily sulfur dioxide emissions by at least 10 tons compared to coal generation power; (3) expand by 75 percent the domestic solar photovoltaic market in the United States (measured in megawatts) as compared to the expansion of that market from 2001 to 2002; and (4) use at least 25 megawatts of fuel cell energy generation.

Each project must certify to the Secretary, no later than 30 days after the completion of the project, that the net benefit of the tax-exempt financing was used for the purposes described in the project application. In addition, no bond proceeds can be used to provide any facility the principal business of which is the sale of food or alcoholic beverages for consumption on the premises.

Special rules

The provision requires each issuer to maintain, on behalf of each project, an interest bearing reserve account equal to one percent of the net proceeds of any qualified green bond issued for such project. Not later than five years after the date of issuance, the Secretary, after consultation with the Administrator, shall determine whether the project financed with the proceeds of qualified green bonds has substantially complied with the requirements and goals described in the project application. If the Secretary, after such consultation, certifies that the project has substantially complied with the requirements and goals, amounts in the reserve

[199] The term "rural State" means any State that has (1) a population of less than 4.5 million according to the 2000 census; (2) a population density of less than 150 people per square mile according to the 2000 census; and (3) increased in population by less than half the rate of the national increase between the 1990 and 2000 censuses.

account, including all interest, shall be released to the project. If the Secretary determines that the project has not substantially complied with such requirements and goals, amounts in the reserve account, including all interest, shall be paid to the United States Treasury.

Effective date.–The provision is effective for bonds issued after December 31, 2004, and before October 1, 2009.

Conference Agreement

The conference agreement follows the Senate amendment.

J. Manufacturing Relating to Films

1. Special rules for certain film and television production (sec. 321 of the Senate amendment and new sec. 181 of the Code)

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

House Bill

No provision.

Senate Amendment

The Senate amendment permits qualifying film and television productions to elect to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[200]

The provision limits the amount of production expenditures that may be expensed to $15 million for each qualifying production.[201] An additional $5 million of production expenditures

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[200] An election to deduct such costs shall be made in such manner as prescribed by the Secretary and by the due date (including extensions of time) for filing the taxpayer's return of tax for the taxable year in which production costs of such property are first incurred. An election may not be revoked without the consent of the Secretary. The Committee intends that, in the absence of specific guidance by the Secretary, deducting qualifying costs on the appropriate tax return shall constitute a valid election.

may be deducted (up to $20 million in total) if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. Expenditures in excess of $15 million ($20 million in distressed areas) are required to be recovered over a three-year period using the straight-line method beginning in the month such property is placed in service.

The provision defines a qualified film or television production as any production of a motion picture (whether released theatrically or directly to video cassette or any other format); miniseries; scripted, dramatic television episode; or movie of the week if at least 75 percent of the total compensation expended on the production are for services performed in the United States.[202] With respect to property which is one or more episodes in a television series, only the first 44 episodes qualify under the provision. Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

Effective date.–The Senate amendment is effective for qualified productions commencing after the date of enactment and sunsets for qualifying productions commencing after December 31, 2008.

Conference Agreement

The conference agreement follows the Senate amendment, except that the provision does not apply to qualified productions the aggregate cost of which exceeds the $15 million threshold. The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.

Effective date.–The provision is effective for qualified productions commencing after the date of enactment and before January 1, 2009.[203]

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[201] Thus, a qualifying film that is co-produced is limited to $15 million of deduction. The benefits of this provision shall be allocated among the owners of a film in a manner that reasonably reflects each owner's proportionate investment in and economic interest in the film.

[202] The term compensation does not include participations and residuals.

[203] For this purpose, a production is treated as commencing on the first date of principal photography.

2. Modification of application of income forecast method of depreciation (sec. 322 of the Senate amendment and sec. 167 of the Code)

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Income forecast method of depreciation

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in section 167(g)(1)(A)). For purposes of the provision, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. The provision also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property.

The provision also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

In addition, the provision clarifies that, in the case of property eligible for the income forecast method that the holding in the *Associated Patentees*[204] decision will continue to constitute a valid method. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid as under the *Associated Patentees* decision. This may be done on a property-by-property basis and shall be applied consistently with respect to a given property thereafter. The provision also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective date.–The Senate amendment applies to property placed in service after date of enactment. No inference is intended as to the appropriate treatment under present law. It is intended that the Treasury Department and the IRS expedite the resolution of open cases. In resolving these cases in an expedited and balanced manner, the Treasury Department and IRS are encouraged to take into account the principles of the provision.

Conference Agreement

The conference agreement follows the Senate amendment.

[204] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

TITLE III – PROVISIONS RELATING TO TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES

1. Interest expense allocation rules (sec. 301 of the House bill, sec. 205 of the Senate amendment, and sec. 864 of the Code)

Present Law

In general

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

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[205] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

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

Definition of affiliated group – consolidated return rules

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

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

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

Definition of affiliated group – special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[206] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

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

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

House Bill

In general

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

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

(i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[207] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[208]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[209] as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[210] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

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

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

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

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

In addition, if an affiliated group elects to apply the new elective rules based on worldwide fungibility, the present-law rules regarding the treatment of tax-exempt assets and the basis of stock in nonaffiliated 10-percent owned corporations apply on a worldwide affiliated group basis.

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

Financial institution group election

The provision allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group. Under the provision, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[211] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

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

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2008.

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

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

2. Recharacterize overall domestic loss (sec. 302 of the House bill, sec. 204 of the Senate amendment, and sec. 904 of the Code)

Present Law

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

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

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

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

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

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

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

House Bill

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

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

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

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

Effective date.–The provision applies to losses incurred in taxable years beginning after December 31, 2006.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

3. Foreign tax credit baskets and "base differences" (sec. 303 of the House bill, sec. 225 of the Senate amendment, and sec. 904 of the Code)

Present Law

In general

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

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[212] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). In addition, a number of other provisions of the Code and U.S. tax treaties effectively create additional separate limitations in certain circumstances.[213]

Financial services income

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

Treasury regulations provide that a person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any year if for that year at least 80 percent of its gross income is "active financing income."[214] The regulations further provide that a corporation that is not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business under the preceding definition can derive financial services income if the corporation is a member of an affiliated group (as defined in section 1504(a), but expanded to include foreign corporations) that, as a whole, meets the regulatory test

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

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

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

of being “predominantly engaged.”[215] In determining whether an affiliated group is “predominantly engaged,” only the income of members of the group that are U.S. corporations, or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of the total voting power and value of the stock, are counted.

“Base difference” items

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[216] In cases in which foreign law imposes tax on an item of income that does not constitute income under U.S. tax principles (a “base difference” item), the tax is treated as imposed on income in the general limitation category.[217]

House Bill

In general

The provision generally reduces the number of foreign tax credit limitation categories to two: passive category income and general category income. Other income is included in one of the two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation category, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation category. The provision does not affect the separate computation of foreign tax credit limitations under special provisions of the Code relating to, for example, treaty-based sourcing rules or specified countries under section 901(j).

Financial services income

In the case of a member of a financial services group or any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business, the provision treats income meeting the definition of financial services income as general category income. Under the provision, a financial services group is an affiliated group that is predominantly engaged in the active conduct of a banking, insurance, financing or similar business. For this purpose, the definition of an affiliated group under section 1504(a) is applied, but expanded to include certain insurance companies (without regard to whether such companies are covered by an election under section 1504(c)(2)) and foreign corporations. In determining whether such a group is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are U.S.

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

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

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

corporations or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of total voting power and value of the stock are taken into account.

The provision does not alter the present law interpretation of what it means to be a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business."[218] Thus, other provisions of the Code that rely on this same concept of a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" are not affected by the provision. For example, under the "accumulated deficit rule" of section 952(c)(1)(B), subpart F income inclusions of a U.S. shareholder attributable to a "qualified activity" of a controlled foreign corporation may be reduced by the amount of the U.S. shareholder's pro rata share of certain prior year deficits attributable to the same qualified activity. In the case of a qualified financial institution, qualified activity consists of any activity giving rise to foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Similarly, in the case of a qualified insurance company, qualified activity consists of activity giving rise to insurance income or foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. For this purpose, "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" is defined under present law by reference to the use of the term for purposes of the separate foreign tax credit limitations.[219] The present-law meaning of "predominantly engaged" for purposes of section 952(c)(1)(B) remains unchanged under the provision.

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

"Base difference" items

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

Effective date.–The provision is effective for taxable years beginning after December 31, 2006. Taxes paid or accrued in a taxable year beginning before January 1, 2007, and carried to any subsequent taxable year are treated as if this provision were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories, as appropriate. The Treasury Secretary is given authority to provide by

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

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

regulations for the allocation of income with respect to taxes carried back to pre-effective-date years (in which more than two limitation categories are in effect).

Senate Amendment

Under the provision, creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed either on general limitation income or on financial services income, at the taxpayer's election. Once made, this election applies to all such taxes and is revocable only with the consent of the Secretary.

Effective date.–The provision is effective for taxable years ending after date of enactment.

Conference Agreement

The conference agreement follows the House bill, with a modification relating to base differences. As in the House bill, creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed on general limitation income, as of the general effective date of the House bill provision. The conference agreement adds a provision under which any such taxes arising in taxable years beginning after December 31, 2004, but before January 1, 2007 (when the number of limitation categories is reduced to two), are treated as imposed on either general limitation income or financial services income, at the taxpayer's election. Once made, this election applies to all such taxes for the taxable years described above and is revocable only with the consent of the Treasury Secretary.

4. Apply look-through rules for dividends from noncontrolled section 902 corporations (sec. 304 of the House bill, sec. 202 of the Senate amendment, and sec. 904 of the Code)

Present Law

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

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).[220] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a

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

10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach).

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

House Bill

The provision generally applies the look-through approach to dividends paid by a 10/50 company regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.[221] If the Treasury Secretary determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 company to the proper foreign tax credit limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes.[222]

Effective date.–The provision is effective for taxable years beginning after December 31, 2002. The provision also provides transition rules regarding the use of pre-effective-date foreign tax credits associated with a 10/50-company separate limitation category in post-effective-date years. Look-through principles similar to those applicable to post-effective-date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. The provision allows the Treasury Secretary to issue regulations addressing the carryback of foreign tax credits associated with a dividend from a 10/50 company to pre-effective-date years.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

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

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

5. Attribution of stock ownership through partnerships in determining section 902 and 960 credits (sec. 305 of the House bill, sec. 213 of the Senate amendment, and sec. 902 of the Code)

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation is eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of the dividend to the foreign corporation's post-1986 undistributed earnings and profits.

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

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

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning 10 percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[223] In Rev. Rul. 71-141,[224]

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

[224] 1971-1 C.B. 211.

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

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[225] In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, uncertainty remains regarding whether a domestic corporation owning 10 percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

House Bill

The provision clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership, provided that the domestic corporation owns (indirectly through the partnership) 10 percent or more of the foreign corporation's voting stock. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The provision also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

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

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

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

6. Foreign tax credit treatment of deemed payments under section 367(d) of the Code (sec. 306 of the House bill, sec. 229 of the Senate amendment, and sec. 367(d) of the Code)

Present Law

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

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[226]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[227] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[228]

House Bill

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

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

Senate Amendment

The Senate amendment is the same as the House bill.

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

[227] Sec. 904(d).

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

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

7. United States property not to include certain assets of controlled foreign corporations (sec. 307 of the House bill, sec. 227 of the Senate amendment, and sec. 956 of the Code)

Present Law

In general, the subpart F rules[229] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year.[230]

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[231] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[232] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[233]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person,

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[229] Secs. 951-964.

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

[231] Sec. 956(a).

[232] Secs. 956 and 959.

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

and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[234]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[235]

House Bill

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

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

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

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

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

Effective date.–The House bill provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

8. Election not to use average exchange rate for foreign tax paid other than in functional currency (sec. 308 of the House bill, sec. 224 of the Senate amendment, and sec. 986 of the Code)

Present Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.[236] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[237]

House Bill

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the House bill provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional

[236] Sec. 986(a)(1).

[237] Sec. 986(a)(2).

currency.[238] Any election under the provision applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The House bill authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

Effective date.–The House bill provision is effective with respect to taxable years beginning after December 31, 2004.

Senate Amendment

The Senate amendment is the same as the House bill.

Effective date.–The Senate amendment provision is effective with respect to taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. In addition, the conference agreement provides that the election does not apply to regulated investment companies that take into account income on an accrual basis. Instead, the conference agreement provides that foreign income taxes paid or accrued by a regulated investment company with respect to such income are translated into U.S. dollar amounts using the exchange rate as of the date the income accrues.

9. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations (sec. 309 of the House bill, sec. 215 of the Senate amendment, and sec. 871 of the Code)

Present Law

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

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources.

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

Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

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

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

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

House Bill

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

Effective date.–The provision is effective for payments made after December 31, 2004.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

10. Equal treatment for interest paid by foreign partnerships and foreign corporations (sec. 310 of the House bill, sec. 228 of the Senate amendment, and sec. 861 of the Code)

Present Law

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[239] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[240] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[241]

House Bill

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

Effective date.–This House bill provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

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

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

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

11. Look-through treatment of payments between related controlled foreign corporations (sec. 311 of the House bill, sec. 222 of the Senate amendment, and sec. 954 of the Code)

Present Law

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

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

House Bill

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

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

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or Senate amendment provision.

12. Look-through treatment under subpart F for sales of partnership interests (sec. 312 of the House bill, sec. 223 of the Senate amendment, and sec. 954 of the Code)

Present Law

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

House Bill

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

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

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

13. Repeal of foreign personal holding company rules and foreign investment company rules (sec. 313 of the House bill, sec. 211 of the Senate amendment, and secs. 542, 551-558, 954, 1246, and 1247 of the Code)

Present Law

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

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

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

House Bill

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

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

Senate Amendment

The Senate amendment provision is the same as the House bill provision.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

14. Determination of foreign personal holding company income with respect to transactions in commodities (sec. 314 of the House bill, sec. 206 of the Senate amendment, and sec. 954 of the Code)

Present Law

Subpart F foreign personal holding company income

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

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

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[242] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of

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

commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[243]

Hedging transactions

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[244] The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations.[245]

House Bill

The House bill modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the House bill, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of the House bill, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2).[246]

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

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

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

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

The House bill also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the House bill, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[247]

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

Effective date.–The House bill provision is effective with respect to transactions entered into after December 31, 2004.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

15. Modifications to treatment of aircraft leasing and shipping income (sec. 315 of the House bill, sec. 221 of the Senate amendment, and sec. 954 of the Code)

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include currently in income for U.S. tax purposes certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In

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

effect, the Code treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of their pro rata shares of the CFC's subpart F income. The amounts included in income by the CFC's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

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

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

Subpart F foreign personal holding company income does not include rents and royalties received by a CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). The determination of whether rents or royalties are derived in the active conduct of a trade or business is based on all the facts and circumstances. However, the Treasury regulations provide certain types of rents are treated as derived in the active conduct of a trade or business. These include rents derived from property that is leased as a result of the performance of marketing functions by the lessor if the lessor (through its own officers or employees located in a foreign country) maintains and operates an organization in such country that regularly engages in the business of marketing, or marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property. An organization in a foreign country is substantial in relation to rents if the active leasing expenses[248] equal at least 25 percent of the adjusted leasing profit.[249]

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

House Bill

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

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

An aircraft or vessel is considered to be leased in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and one

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

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

in a foreign country or between foreign ports (or airports), provided the aircraft or vessel is used predominantly outside the United States. An aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is located outside the United States more than 50 percent of the time during such taxable year.

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

It is anticipated that taxpayers now eligible for the benefits of the ETI exclusion (or the FSC provisions pursuant to the FSC Repeal and Extraterritorial Income Exclusion Act of 2000), will find it appropriate, as matter of sound business judgment, to restructure their business operations to take into account the tax law changes brought about by the bill. It is noted that courts have recognized the validity of structuring operations for the purpose of obtaining the benefit of tax regimes expressly intended by Congress. It is intended that structuring or restructuring of operations for the purposes of adapting to the repeal of the ETI exclusion (or the FSC regime) will be considered to serve a valid business purpose and will not constitute tax avoidance, where the restructured operations conform to the requirements expressly mandated by Congress for obtaining tax benefits that remain available. For example, it is intended that a restructuring undertaken to transfer aircraft subject to existing FSC or ETI leases to a CFC lessor, to take advantage of the amendments made by this bill, would serve a valid business purpose and would not constitute tax avoidance, for purposes of determining whether a particular tax treatment (such as nonrecognition of gain) applies to such restructuring. It is intended, for example, that if such a restructuring meets the other requirements necessary to qualify as a "reorganization" under section 368, the transaction will also be deemed to meet the "business purpose" requirements under section 368, and thus, qualify as a reorganization under that section.

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

Senate Amendment

The provision provides that "qualified leasing income" derived from or in connection with the leasing or rental of any aircraft or vessel is not treated as foreign personal holding company income or foreign base company shipping income of a controlled foreign corporation. The provision defines "qualified leasing income" as rents or gains derived in the active conduct of a leasing trade or business with respect to which the controlled foreign corporation conducts substantial activity, provided that the leased property is used by the lessee or other end-user in foreign commerce and predominantly outside the United States, and such lessee or other end-user is not related to the controlled foreign corporation (within the meaning of sec. 954(d)(3)).

In determining whether an aircraft or vessel is used in foreign commerce, it is intended that foreign commerce encompass the use of an aircraft or vessel in the transportation of property or passengers: (1) between an airport or port in the United States (including for this purpose any possession of the United States) and an airport or port in a foreign country; (2) between an airport or port in a foreign country and another in the same country; or (3) between an airport or port in a foreign country and another in a different foreign country. It is intended that an aircraft or vessel be considered as used predominantly outside the United States if more than 70 percent of its miles traveled during the taxable year are traveled outside the United States, or if the aircraft or vessel is located outside the United States for more than 70 percent of the time during the taxable year.

Effective date.–The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Conference Agreement

The conference agreement follows the House bill with the following clarifications. First, the terms "aircraft or vessels" include engines that are leased separately from an aircraft or vessel. Second, if a lessor acquires (from a related or unrelated party) or aircraft or vessel subject to an existing lease, the requirements of section 954(c)(2)(A) are satisfied if, following the acquisition, the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property. However, if an existing FSC or ETI lease is transferred to a CFC lessor, the lease will no longer be eligible for FSC or ETI benefits.

16. Modification of exceptions under subpart F for active financing (sec. 316 of the House bill, sec. 226 of the Senate amendment, and sec. 954 of the Code)

Present Law

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

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

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[250]

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

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

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

House Bill

The House bill modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the House bill provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country. For purposes of determining whether a CFC or QBU is eligible to earn active financing income, such activity may not be taken into account by any CFC or QBU (including the employer of the employees performing the activity) other than the CFC or QBU for which the activities are performed.

Effective date.–The House bill provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

17. Ten-year foreign tax credit carryover; one-year foreign tax credit carryback (sec. 201 of the Senate amendment and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to a portion of the taxpayer's U.S. tax which portion is calculated by multiplying the taxpayer's total U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) and the denominator of which is the taxpayer's worldwide taxable income for the year.[251]

[251] Section 904(a).

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

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years (to the earliest year first) and carried forward five taxable years (in chronological order) and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. Excess credits that are carried back or forward are usable only to the extent that there is excess foreign tax credit limitation in such carryover or carryback year. Consequently, foreign tax credits arising in a taxable year are utilized before excess credits from another taxable year may be carried forward or backward. In addition, excess credits are carried forward or carried back on a separate limitation basis. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits may be carried back and forward only as taxes allocable to that category, notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year. If credits cannot be so utilized, they are permanently disallowed.

House Bill

No provision.

Senate Amendment

The provision extends the excess foreign tax credit carryforward period to twenty years and limits the carryback period to one year.

Effective date.–The extension of the carryforward period is effective for excess foreign tax credits that may be carried to any taxable years ending after the date of enactment of the provision; the limited carryback period is effective for excess foreign tax credits arising in taxable years beginning after the date of enactment of the provision.

Conference Agreement

The conference agreement follows the Senate amendment, with the modification that the foreign tax credit carryforward period is extended to 10 years.

18. Expand the subpart F de minimis rule to the lesser of five percent of gross income or $5 million (sec. 212 of the Senate amendment and sec. 954 of the Code)

Present Law

Under the rules of subpart F (secs. 951-964), U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income and certain insurance income. Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). Under a de minimis rule, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $1 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income (sec. 954(b)(3)(A)).

House Bill

No provision.

Senate Amendment

The provision expands the subpart F de minimis rule to provide that, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $5 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income.

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

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

19. Limit application of uniform capitalization rules in the case of foreign persons (sec. 214 of the Senate amendment and sec. 263A of the Code)

Present Law

Taxpayers generally may not currently deduct the costs incurred in producing property or acquiring property for resale. In general, the uniform capitalization rules require that a portion of the direct and indirect costs of producing property or acquiring property for resale be capitalized or included in the cost of inventory (sec. 263A). Consequently, such costs must be recovered through an offset to the sales price if the property is produced for sale, or through depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. The purpose of this requirement is to match the costs of producing or acquiring goods with the revenues realized from their sale or use in the business or investment activity.

The uniform capitalization rules apply to foreign corporations, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in a trade or business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation may be currently includible on the return of a U.S. shareholder of the controlled foreign corporation. Regardless of whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the amount of taxable dividends and the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The earnings and profits surplus or deficit of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations. However, proposed regulations provide that, for purposes of computing a foreign corporation’s earnings and profits, the amount of expenses that must be capitalized into inventory under the uniform capitalization rules may not exceed the amount capitalized in keeping the taxpayer’s books and records.[252] For this purpose, the taxpayer’s books and records must be prepared in accordance with U.S. generally accepted accounting principles for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates. This proposed regulation applies only for purposes of determining a foreign corporation’s earnings and profits and does not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

House Bill

No provision.

Senate Amendment

The provision provides that, in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale are capitalized using U.S. generally accepted accounting principles (i.e., the method used to ascertain income, profit, or loss for purposes of reports or statements to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes) for purposes of determining a U.S.-owned foreign corporation’s earnings and profits and subpart F income. The uniform capitalization rules continue to apply to foreign corporations for purposes of determining income effectively connected with a U.S. trade or business and the related earnings and profits therefrom. Any change in the taxpayer’s method of accounting required as a result of this provision is treated as a voluntary change initiated by the taxpayer and is deemed made with the consent of the Secretary of the Treasury (i.e., no application for change in method of accounting is required to be filed with the Secretary). Any resultant section 481(a) adjustment required to be taken into account is to be taken into account in the first year.

Effective date.–The provision applies to taxable years beginning after December 31, 2004.

[252] Treas. Prop. Reg. sec. 1.964-1(c)(1)(ii)(B).

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

20. Eliminate the 30-percent tax on certain U.S.-source capital gains of nonresident individuals (sec. 216 of the Senate amendment and sec. 871 of the Code)

Present Law

In general, resident aliens are taxed in the same manner as U.S. citizens. Nonresident aliens are subject to (1) U.S. tax on income from U.S. sources that are effectively connected with a U.S. trade or business, and (2) a 30-percent withholding tax on the gross amount of certain types of passive income derived from U.S. sources, such as interest, dividends, rents, and other fixed or determinable annual or periodical income (sec. 871(a)(1)). Bilateral income tax treaties may modify these tax rules.

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller (sec. 865(a)). Thus, nonresident aliens generally are not taxable on capital gains because the gains generally are considered to be foreign-source income.[253]

Special rules apply in the case of sales of personal property by certain foreign persons. In this regard, an individual who is otherwise treated as a nonresident is treated as a U.S. resident for purposes of sourcing income from the sale of personal property if the individual has a tax home in the United States (sec. 865(g)(1)(A)(i)(II)). An individual's U.S. tax home generally is the place where the individual has his or her principal place of business. For example, if a nonresident individual with a tax home in the United States sells stocks or other securities for a gain, the individual will be treated as a U.S. resident with respect to the sale such that the gain will be treated as U.S.-source income potentially subject to U.S. tax.

Under the special capital gains tax of section 871(a)(2), a nonresident individual who is physically present in the United States for 183 days or more during a taxable year is subject to a 30-percent tax on the excess of U.S.-source capital gains over U.S.-source capital losses. This 30-percent tax is not a withholding tax. The tax under section 871(a)(2) does not apply to gains and losses subject to the gross 30-percent withholding tax under section 871(a)(1) or to gains effectively connected with a U.S. trade or business. Capital gains and losses are taken into account only to the extent that they would be recognized and taken into account if such gains and losses were effectively connected with a U.S. trade or business. Capital loss carryovers are not taken into account.

As a practical matter, the special rule under section 871(a)(2) applies only in a very limited set of cases. In order for the rule to apply, two conditions must be satisfied: (1) the

[253] Nonresident individuals are subject to the 30-percent gross withholding tax, for example, with respect to gains from the sale or exchange of intangible property if the payments are contingent on the productivity, use, or disposition of the property. Secs. 871(a)(1)(D) and 881(a)(4).

individual must spend at least 183 days in the United States during a taxable year without being treated as a U.S. resident, and (2) the individual's capital gains must be from U.S. sources. If these conditions are satisfied, then the 30-percent tax applies to the excess of U.S.-source capital gains over U.S.-source capital losses. However, section 871(a)(2) generally is not applicable because if the individual spends 183 days or more in the United States in most cases he or she would be treated as a U.S. resident, or if not treated as a U.S. resident, would generally not have U.S.-source capital gains.

An individual who is not a citizen and who spends 183 days or more in the United States during a calendar year generally would be treated as a U.S. resident under the substantial presence test of section 7701(b). Thus, in most cases, the individual who spends at least 183 days in the United States would not be subject to section 871(a)(2).[254] However, under the substantial presence test under section 7701(b), certain days of physical presence in the United States are not counted for purposes of meeting the 183-day rule. This includes days spent in the United States in which the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico; the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours; the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession; and certain exempt individuals. These exceptions from counting physical presence in the United States do not apply, however, for purposes of the special rule under section 871(a)(2). Thus, it is possible in certain cases for an individual to be present in the United States for at least 183 days without being treated as a U.S. resident under the substantial presence test of section 7701(b).[255]

Even if an individual spends at least 183 days in the United States but is not treated as a U.S. resident under section 7701(b), the nonresident individual's capital gains generally will be treated as foreign-source income and, thus, not subject to section 871(a)(2). In this regard, capital gains generally are from foreign sources if the individual is a nonresident, and from U.S. sources if the individual is a U.S. resident. Under a special rule, an individual is treated as a U.S. resident for sales of personal property (including sales giving rise to capital gains) if the

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[254] See the American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 112-113 (1987) (recommending that sec. 871(a)(2) be eliminated and stating "[u]nder Section 7701(b), enacted in 1984, an individual physically present in the U.S. for 183 days in a calendar year is considered a resident, taxable at net income rates on all of his income; and accordingly the justification for Section 871(a)(2) no longer exists." [footnotes omitted]).

[255] It should be noted that there also is a difference with respect to the year over which the 183-day rule is measured for purposes of the substantial presence test and the rule under sec. 871(a)(2). The sec. 871(a)(2) tax applies to 183 days or more of presence in the United States during the taxable year, while the substantial presence test under sec. 7701(b) applies to 183 days or more of presence in the United States during the calendar year. In most cases, however, a nonresident individual's taxable year is the calendar year. Secs. 7701(b)(9) and 871(a)(2).

individual has a tax home in the United States. This rule applies even if the individual is treated as a nonresident for other U.S. tax purposes. An individual's capital gains would be treated as U.S.-source income and potentially subject to section 871(a)(2) if the individual is treated as a U.S. resident under this special rule.[256]

Even in the limited cases in which the special rule under section 871(a)(2) could potentially apply, a tax treaty might prevent its application.[257]

House Bill

No provision.

Senate Amendment

The provision repeals the special tax on certain capital gains of nonresident aliens under section 871(a)(2).

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

21. Modify FIRPTA rules for real estate investment trusts (sec. 230 of the Senate amendment and secs. 857 and 897 of the Code)

Present Law

A real estate investment trust ("REIT") is a U.S. entity that derives most of its income from passive real estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT, and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level.

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[256] The individual's income also could be treated as U.S.-source income under sec. 865(e)(2) if the individual derives income from the sale of personal property that is attributable to an office or other fixed place of business that the individual maintains in the United States. However, sec. 871(a)(2) would not apply if the income is effectively connected with a U.S. trade or business, or if the sale qualifies for the exception from U.S.-source treatment as a result of a material participation in the sale by a foreign office of the taxpayer.

[257] Under Article 13(5) of the U.S. model income tax treaty, subject to certain exceptions, the capital gains of a nonresident individual are exempt from U.S. taxation.

A REIT generally is required to distribute 90 percent of its income to its investors before the end of its taxable year.

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property, including certain transactions involving REITs. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA").

In general, FIRPTA provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a U.S. trade or business during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons. For these purposes, the receipt of a distribution from a REIT is treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT. These capital gains distributions from REITs generally are subject to withholding tax at a rate of 35 percent (or a lower treaty rate). In addition, the recipients of these capital gains distributions are required to file Federal income tax returns in the United States, since the recipients are treated as earning income effectively connected with a U.S. trade or business.

In addition, foreign corporations that have effectively connected income generally are subject to the branch profits tax at a 30-percent rate (or a lower treaty rate).

House Bill

No provision.

Senate Amendment

The provision removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT, provided that (1) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the United States and (2) the foreign investor does not own more than five percent of the class of stock at any time during the taxable year within which the distribution is received.

Thus, a foreign investor is not required to file a U.S. Federal income tax return by reason of receiving such a distribution. The distribution is to be treated as a REIT dividend to that investor, taxed as a REIT dividend that is not a capital gain. Also, the branch profits tax no longer applies to such a distribution.

Effective date.–The provision applies to taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

22. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals (sec. 232 of the Senate amendment and sec. 872 of the Code)

Present Law

Under section 871, certain items of gross income received by a nonresident alien from sources within the United States are subject to a flat 30-percent withholding tax. Gambling winnings received by a nonresident alien from wagers placed in the United States are U.S.-source and thus generally are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S.-source gambling winnings of residents of the other treaty country from U.S. withholding tax. In addition, no withholding tax is imposed under section 871 on the non-business gambling income of a nonresident alien from wagers on the following games (except to the extent that the Secretary determines that collection of the tax would be administratively feasible): blackjack, baccarat, craps, roulette, and big-6 wheel. Various other (non-gambling-related) items of income of a nonresident alien are excluded from gross income under section 872(b) and are thereby exempt from the 30-percent withholding tax, without any authority for the Secretary to impose the tax by regulation. In cases in which a withholding tax on gambling winnings applies, section 1441(a) of the Code requires the party making the winning payout to withhold the appropriate amount and makes that party responsible for amounts not withheld.

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[258] event taking place within the United States, the source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

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[258] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

House Bill

No provision.

Senate Amendment

The provision provides an exclusion from gross income under section 872(b) for winnings paid to a nonresident alien resulting from a legal wager initiated outside the United States in a pari-mutuel pool on a live horse or dog race in the United States, regardless of whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Effective date.–The provision is effective for wagers made after the date of enactment of the provision.

Conference Agreement

The conference agreement follows the Senate amendment.

23. Limitation of withholding on U.S.-source dividends paid to Puerto Rico corporation (sec. 233 of the Senate amendment and secs. 881 and 1442 of the Code)

Present Law

In general, dividends paid by corporations organized in the United States[259] to corporations organized outside of the United States and its possessions are subject to U.S. income tax withholding at the flat rate of 30 percent. The rate may be reduced or eliminated under a tax treaty. Dividends paid by U.S. corporations to corporations organized in certain U.S. possessions are subject to different rules.[260] Corporations organized in the U.S. possessions of the Virgin Islands, Guam, American Samoa or the Northern Mariana Islands are not subject to withholding tax on dividends from corporations organized in the United States, provided that certain local ownership and activity requirements are met. Each of those possessions have adopted local internal revenue codes that provide a zero rate of withholding tax on dividends paid by corporations organized in the possession to corporations organized in the United States.

Under the tax laws of Puerto Rico, which is also a U.S. possession, a 10 percent withholding tax is imposed on dividends paid by Puerto Rico corporations to non-Puerto Rico corporations.[261] Dividends paid by corporations organized in the United States to Puerto Rico

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[259] The term "United States" does not include its possessions. Sec. 7701(a)(9).

[260] The usual method of effecting a mitigation of the flat 30 percent rate - an income tax treaty providing for a lower rate - is not possible in the case of a possession. *See* S. Rep. No. 1707, 89th Cong., 2d Sess. 34 (1966).

[261] The 10 percent withholding rate may be subject to exemption or elimination if the dividend is paid out of income that is subject to certain tax incentives offered by Puerto Rico. These tax incentives may also reduce the rate of underlying Puerto Rico corporate tax to a flat rate of between two and seven percent.

corporations are subject to U.S. withholding tax at a 30 percent rate. Under Puerto Rico law, Puerto Rico corporations may elect to credit their U.S. income taxes against their Puerto Rico income taxes. Creditable income taxes include the 30 percent dividend withholding tax and the underlying U.S. corporate tax attributable to the dividends. However, a Puerto Rico corporation's tax credit for U.S. income taxes may be limited because the sum of the U.S. withholding tax and the underlying U.S. corporate tax generally exceeds the amount of Puerto Rico corporate income tax imposed on the dividend. Consequently, Puerto Rico corporations with subsidiaries organized in the United States may be subject to some degree of double taxation on their U.S. subsidiaries' earnings.

House Bill

No provision.

Senate Amendment

The provision lowers the withholding income tax rate on U.S. source dividends paid to a corporation created or organized in Puerto Rico from 30 percent to 10 percent, to create parity with the generally applicable 10 percent withholding tax imposed by Puerto Rico on dividends paid to U.S. corporations. The lower rate applies only if the same local ownership and activity requirements are met that are applicable to corporations organized in other possessions receiving dividends from corporations organized in the United States.

Effective date.–The provision is effective for dividends paid after date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with modifications. Under the provision as modified, if the generally applicable withholding tax rate imposed by Puerto Rico on dividends paid to U.S. corporations increases to greater than 10 percent, the U.S. withholding rate on dividends to Puerto Rico corporations reverts to 30 percent.

24. Require Commerce Department report on adverse decisions of the World Trade Organization (sec. 234 of the Senate amendment)

Present Law

The Secretary of Commerce does not have an obligation to transmit any future report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means, in consultation with the United States Trade Representative, regarding whether dispute settlement panels or the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, or safeguard measures not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, or the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

House Bill

No provision.

Senate Amendment

The provision requires that by no later than March 31, 2004, the Secretary of Commerce, in consultation with the United States Trade Representative, shall transmit a report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means regarding whether dispute settlement panels or the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, or safeguard measures not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, or the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

25. Study of impact of international tax law on taxpayers other than large corporations (sec. 235 of the Senate amendment)

Present Law

The United States employs a "worldwide" tax system, under which U.S. persons (including domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including foreign corporations) are subject to U.S. tax only on U.S.-source income and income that has a sufficient nexus to the United States. The United States generally provides a credit to U.S. persons for foreign income taxes paid or accrued.[262] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[263]

Within this basic framework, there are a variety of rules that affect the U.S. taxation of cross-border transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S.-source income. Such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or

[262] Sec. 901.

[263] Secs. 901, 904.

otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign-source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deductions between related persons in order to ensure the clear reflection of the income of each person and to prevent the avoidance of tax. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on certain income from foreign operations of certain U.S.-owned foreign corporations.

A cross-border transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and mitigate the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

House Bill

No provision.

Senate Amendment

The provision requires the Secretary of the Treasury or the Secretary's delegate to conduct a study of the impact of Federal international tax rules on taxpayers other than large corporations, including the burdens placed on such taxpayers in complying with such rules. In addition, not later than 180 days after the date of the enactment of this provision, the Secretary shall report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives the results of the study conducted as a result of this provision, including any recommendations for legislative or administrative changes to reduce the compliance burden on taxpayers other than large corporations and for such other purposes as the Secretary determines appropriate.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

26. Delay in effective date of final regulations governing exclusion of income from international operations of ships and aircraft (sec. 236 of the Senate amendment and sec. 883 of the Code)

Present Law

Section 883 generally provides an exemption from gross income for earnings of a foreign corporation derived from the international operation of ships and aircraft if an equivalent exemption from tax is granted by the applicable foreign country to corporations organized in the United States.

Treasury has issued regulations implementing the rules of section 883 that are effective for taxable years beginning 30 days or more after August 26, 2003. The regulations provide, in general, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft shall exclude qualified income from gross income for purposes of United States Federal income taxation, provided that the corporation can satisfy certain ownership and related documentation requirements. The proposed rules explain when a foreign country is a qualified foreign country and what income is considered to be qualified income.

House Bill

No provision.

Senate Amendment

The provision delays the effective date for the Treasury regulations so that they apply to taxable years of foreign corporations seeking qualified foreign corporation status beginning after December 31, 2004.

Effective date.–The provision is effective after date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment, except the regulations apply to taxable years of foreign corporations seeking qualified foreign corporation status beginning after September 24, 2004.

27. Interest payments deductible where taxpayer could have borrowed without a guarantee (sec. 237 of the Senate amendment and sec. 163(j) of the Code)

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. These rules limit the deductibility of interest paid to certain related parties ("disqualified interest"), if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).

Disqualified interest for these purposes also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

House Bill

No provision.

Senate Amendment

Under the provision, a foreign related-party guarantee does not trigger the earnings stripping rules to the extent of the amount of debt that the taxpayer establishes (to the satisfaction of the Treasury Secretary) that it could have borrowed without the guarantee.

Effective date.–The provision is effective for guarantees issued on or after the date of enactment.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

TITLE IV – EXTENSION OF CERTAIN EXPIRING PROVISIONS

1. Nonrefundable personal credits allowed against the alternative minimum tax ("AMT") (sec. 401 of the House bill, sec. 713 of the Senate amendment, and sec. 26 of the Code)

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[264] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2006, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2005, the credits (other than the adoption credit, child credit and credit for savers) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

House Bill[265]

The House bill allows all nonrefundable personal credits against the AMT.

Effective date.–Taxable years beginning in 2004 and 2005.

Senate Amendment[266]

The Senate amendment allows all nonrefundable personal credits against the AMT.

Effective date.–Taxable years beginning in 2004.

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

[265] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[266] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

2. Extension and modification of the research credit (sec. 402 of the House bill, secs. 311 and 312 of the Senate amendment, and sec. 41 of the Code)

Present Law

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. Taxpayers may elect an alternative incremental research credit regime in which the taxpayer is assigned a three-tiered fixed-base percentage and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

The research tax credit generally applies to amounts paid or incurred before January 1, 2006.

House Bill[267]

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

Effective date.–The provision is effective for amounts paid or incurred after June 30, 2004.

Senate Amendment[268]

The Senate amendment is the same as the House bill with respect to extension of the present-law research credit. In addition, the Senate amendment makes the following modifications:

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[267] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[268] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

(4) Increases the credit rates of the alternative incremental credit to three percent, four percent, and five percent.

(5) Creates a third alternative for taxpayers, the alternative simplified credit. The taxpayer may elect to claim a credit equal to 12 percent of qualified research expenses in excess of 50 percent of the average qualified research expenses for the preceding three taxable years.

(6) Permits taxpayers to claim a credit equal to 20 percent of amounts paid to certain research consortia.

The provision also permits taxpayers to include 100 percent of contract research expenses (rather than 65 percent) if the contractor is an eligible small business, a college or university, or a Federal laboratory.

Effective date.–With respect to extension of the present-law research credit, the provision is effective for amounts paid or incurred after the date of enactment.

With respect to the increase in the alternative incremental credit and the alternative simplified credit, the provisions are effective for taxable years beginning after December 31, 2004.

With respect to payments to research consortia and certain contract research, the provisions are effective for amounts paid or incurred after December 31, 2004.

Conference Agreement

The conference agreement does not include the House bill or Senate amendment provision.

3. Extension of credit for electricity produced from certain renewable resources (sec. 403 of the House bill, secs. 714 and 801 of the Senate amendment, and sec. 45 of the Code)

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. The amount of the credit is 1.8 cents per kilowatt hour for 2004. The credit amount is indexed for inflation.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2006, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2006, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2006. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

House Bill[269]

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

Effective date.–The provision is effective for facilities placed in service after December 31, 2003.

Senate Amendment[270]

With respect to extension of the present-law credit, the Senate amendment extends the placed-in-service date for wind, closed-loop biomass, and poultry waste facilities to facilities placed in service prior to January 1, 2007.

(The Senate amendment would also expand the definition of qualified facilities and make certain other modifications to the operation of credit. These expansions and modifications are described later in this document.)

Effective date.–With respect to the extension of the placed-in-service dates, the provision is generally effective for facilities placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or Senate amendment provision with respect to the extension of present law, but it does make modifications to present law that are described later in this document.

4. Indian employment tax credit (sec. 404 of the House bill, sec. 716 of the Senate amendment, and sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees. 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

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[269] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[270] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

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

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2006.

House Bill[271]

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.

Senate Amendment[272]

Same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

[271] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[272] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

5. Extension of the work opportunity tax credit (sec. 405 of the House bill, sec. 702 of the Senate amendment, and sec. 51 of the Code)

<u>Present Law</u>

<u>Work opportunity tax credit</u>

<u>Targeted groups eligible for the credit</u>

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under State or Federal law; (2) being a member of an economically disadvantaged family; and (3) having a hiring date within one year of release from prison or conviction.

<u>Qualified wages</u>

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

<u>Calculation of the credit</u>

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

<u>Minimum employment period</u>

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

<u>Coordination of the work opportunity tax credit and the welfare-to-work tax credit</u>

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

House Bill[273]

The House bill extends the WOTC for two years (through December 31, 2005).

Effective date.–Wages paid or incurred for individuals beginning work after December 31, 2003.

Senate Amendment[274]

The Senate amendment permanently extends the WOTC.

The Senate amendment also makes the following modifications to the WOTC:

(1) repeals the requirement that a qualified ex-felon be a member of an economically disadvantaged family for purposes of eligibility for the tax credit;

(2) expands the category of vocational rehabilitation referrals to include certain individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who are receiving vocational services or have completed an individual work plan developed by a private employment network as defined under section 1148(f) of the Social Security Act qualify as members of the vocational rehabilitation referral targeted group.

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[273] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[274] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"),which included a number of extensions to expiring provisions.

(3) increases the age limit for qualified food stamp recipients. Therefore a food stamp recipient is an individual aged 18 but not aged 40 certified as being a member of a family either currently or recently receiving assistance under an eligible food stamp program.

(4) increases the age limit for high-risk youths. Therefore a high-risk youth is an individual aged 18 but not aged 40 having a principal place of abode within an empowerment zone, enterprise community, or renewal community.

Effective date.–The extension is effective for wages paid or incurred for individuals beginning work after December 31, 2003. The modifications are effective for wages paid or incurred for individuals beginning work after December 31, 2004.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

6. Extension of the welfare-to-work tax credit (sec. 406 of the House bill, sec. 702 of the Senate amendment, and sec. 51A of the Code)

Present Law

Welfare-to-work tax credit

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit which includes simply cash wages, the definition of wages for the welfare-to-work tax credit includes cash wages paid to an employee plus amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. The employer’s deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment. The maximum credit is 35 percent of the first $10,000 of qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Qualified first-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer. The maximum credit is $8,500 per qualified employee.

Minimum employment period

No credit is allowed for qualified wages paid to a member of the targeted group unless they work at least 400 hours or 180 days in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of these other rules contained on the work opportunity tax credit.

Expiration

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

House Bill[275]

The House bill extends the WWTC for two years (through December 31, 2005).

Effective date.–The provision is effective for wages paid or incurred for individuals beginning work after December 31, 2003.

[275] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Senate Amendment[276]

The Senate amendment permanently extends the WWTC.

Effective date.–Wages paid or incurred for individuals beginning work after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

7. Combination and modification of the work opportunity tax credit and the welfare-to-work tax credit (sec. 703 of the Senate amendment and sec. 51 of the Code)

Present Law

Same as items 5 and 6, above.

House Bill[277]

No provision.

Senate Amendment[278]

The Senate amendment combines and modifies the work opportunity and welfare-to-work tax credits with the following modifications:

The combined credit uses the WOTC definition of wages; in the case of first-year wages for long-term family assistance recipients the maximum credit is increased to $4,000 (40 percent of the first $10,000 of qualified first-year wages);

The combined credit uses the WOTC definition for the minimum employment period (i.e., the combined credit is not allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment).

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[276] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[277] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[278] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Effective date.–The provision is effective for wages paid or incurred for individuals beginning work after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Certain expenses of elementary and secondary school teachers (sec. 407 of the House bill, sec. 707 of the Senate amendment, and sec. 62 of the Code)

Present Law

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

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2006, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), section 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

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

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2005.

House Bill[279]

The House bill allows the above-the-line deduction for taxable years beginning prior to January 1, 2006.

Effective date.–The provision is effective for taxable years beginning in 2004 and 2005.

Senate Amendment[280]

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

9. Accelerated depreciation for business property on Indian reservations (sec. 408 of the House bill, sec. 717 of the Senate amendment, and sec. 168 of the Code)

Present Law

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

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

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in

[279] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[280] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

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, 2006.

House Bill[281]

The provision extends eligibility for the special depreciation periods to property placed in service before January 1, 2006.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment[282]

Same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

10. Charitable contributions of computer technology and equipment used for educational purposes and of scientific property used for research (sec. 409 of the House bill, sec. 706 of the Senate amendment, and sec. 170 of the Code)

Present Law

A deduction for charitable contributions of computer technology and equipment and of scientific property used for research generally is limited to the taxpayer's basis in the property. However, certain corporations may claim a deduction in excess of basis for a qualified computer contribution or a qualified research contribution. To be eligible for the enhanced deduction, the contributed property must be constructed by the taxpayer, among other requirements. The

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[281] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[282] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

enhanced deduction for qualified computer contributions expires for contributions made during any taxable year beginning after December 31, 2005.

House Bill[283]

The House bill extends the enhanced deduction for qualified computer contributions to contributions made during any taxable year beginning before January 1, 2006.

Effective date.–Taxable years beginning after December 31, 2003.

Senate Amendment[284]

The Senate amendment expands the enhanced deduction for qualified computer contributions and qualified research contributions to apply to property assembled by the taxpayer as well as property constructed by the taxpayer.

The extension of the enhanced deduction for qualified computer contributions is the same as the House bill.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

11. Expensing of environmental remediation costs (sec. 410 of the House bill, sec. 708 of the Senate amendment, and sec. 198 of the Code)

Present Law

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

Eligible expenditures are those paid or incurred before January 1, 2006.

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[283] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[284] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

House Bill[285]

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

Effective date.–The provision is effective for expenses paid or incurred after December 31, 2003.

Senate Amendment[286]

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or Senate amendment provision.

12. Availability of Archer medical savings accounts (sec. 411 of the House bill and sec. 220 of the Code)

Present Law

In general

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

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high

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[285] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[286] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

deductible health plan.[287] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

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

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

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,600 in the case of individual coverage and at least $3,450 and no more than $5,150 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,450 in the case of individual coverage and no more than $6,300 in the case of family coverage.[288] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

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

After 2005, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer.

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

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

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

The reports required by MSA trustees for 2004 are treated as timely if made within 90 days after October 4, 2004. In addition, the determination of whether 2004 is a cut-off year and the publication of such determination is to be made within 120 days of October 4, 2004. If 2004 is a cut-off year, the cut-off date will be the last day of such 120-day period.

House Bill[289]

The House bill extends Archer MSAs through December 31, 2005.

Effective date.–The provision is effective for January 1, 2004.

Senate Amendment[290]

No provision.

Conference Agreement

The conference agreement does not include the House bill or Senate amendment provision.

13. Suspension of 100-percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (sec. 412 of the House bill, secs. 715 and 846 of the Senate amendment, and sec. 613A of the Code)

Present Law

Overview of depletion

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

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[289] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[290] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

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.[291] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[292] 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 the 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.[293] 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.[294] The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").[295] The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2006.

House Bill[296]

The provision extends the suspension of the net-income limitation for marginal wells for taxable years beginning before January 1, 2006.

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

[292] Secs. 611-613.

[293] Sec. 613A.

[294] Sec. 613A(c).

[295] Sec. 613(a).

[296] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the “Working Families Tax Relief Act of 2004”), which included a number of extensions to expiring provisions.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment[297]

The Senate amendment extends the suspension of the net-income limitation for marginal wells for taxable years beginning before January 1, 2007.

Effective date.–Same as the House bill.

Conference Agreement

The conference agreement does not contain the House bill or Senate amendment provision.

14. Qualified zone academy bonds (sec. 413 of the House bill, secs. 612 and 704 of the Senate amendment, and sec. 1397E of the Code)

Present Law

Generally, "qualified zone academy bonds" are bonds issued by a State or local government, provided that at least 95 percent of the proceeds are used for one or more qualified purposes with respect to a "qualified zone academy" and private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds. Qualified purposes with respect to any qualified zone academy are: (1) rehabilitating or repairing the public school facility in which the academy is established; (2) providing equipment for use at such academy; (3) developing course materials for education at such academy, and (4) training teachers and other school personnel. A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2005.

House Bill[298]

The House bill authorizes $400 million of qualified zone academy bonds to be issued in 2004 and 2005.

Effective date.–The House bill provision is effective for obligations issued after the date of enactment.

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[297] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[298] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Senate Amendment[299]

The Senate amendment expands the qualified purposes for which qualified zone academy bonds may be issued to include construction of the public school facility in which the qualified zone academy is established, and the acquisition of land on which the facility is to be constructed.

The Senate amendment authorizes $400 million of qualified zone academy bonds to be issued in 2004 and 2005.

Effective date.–The Senate amendment is effective for obligations issued after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

15. **Tax Incentives for Investment in the District of Columbia (sec. 414 of the House bill, sec. 711 of the Senate amendment, and secs. 1400, 1400A, and 1400C of the Code)**

Present Law

Certain economically depressed census tracts within the District of Columbia are designated as the District of Columbia Enterprise Zone (the "D.C. Zone") within which businesses and individual residents are eligible for special tax incentives. The designation expires on December 31, 2005.

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The credit expires for property purchased after December 31, 2005.

House Bill[300]

The House bill extends the D.C. Zone designation and related tax incentives for two years, and extends the first-time homebuyer credit for two years.

[299] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[300] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Effective date.–The provision takes effect on the date of enactment, except that the provision relating to tax-exempt financing incentives, which applies to obligations issued after December 31, 2003.

Senate Amendment[301]

Same as the House bill.

Effective date.– The provision takes effect on January 1, 2004, except that the provision relating to tax-exempt financing incentives applies to obligations issued after the date of enactment.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

16. Modifications to New York Liberty Zone bond provisions (sec. 415 of the House bill, secs. 611 and 709 of the Senate amendment, and sec. 1400L of the Code)

Present Law

An aggregate of $8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2010.

Certain bonds used to fund facilities located in New York City are permitted one additional advance refunding before January 1, 2006 ("advance refunding bonds"). In addition to satisfying other requirements, the bond refunded must be (1) a State or local bond that is a general obligation of New York City, (2) a State or local bond issued by the New York Municipal Water Finance Authority or Metropolitan Transportation Authority of the City of New York, or (3) a qualified 501(c)(3) bond which is a qualified hospital bond issued by or on behalf of the State of New York or the City of New York.[302] The maximum amount of advance refunding bonds is $9 billion.

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[301] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[302] On July 8, 2002, the IRS issued Notice 2002-42, which provides that bonds issued by the Municipal Assistance Corporation for the City of New York are eligible for the advance refunding provisions of section 1400L(e) if they otherwise satisfy the requirements of that section.

House Bill[303]

The House bill provision extends authority to issue Liberty Zone bonds through December 31, 2009.

Effective date.–The provision is effective for bonds issued after the date of enactment and before January 1, 2010.

Senate Amendment[304]

The Senate amendment extends authority to issue Liberty Zone bonds through December 31, 2009, and extends the additional advance refunding authority through December 31, 2005. The Senate amendment provides that bonds issued by the Municipal Assistance Corporation are eligible for advance refunding.

Effective date.–The provisions extending authority to issue Liberty Zone bonds and an additional advance refunding are effective on the date of enactment. The provision relating to the advance refunding of bonds of the Municipal Assistance Corporation is effective as if included in the amendments made by section 301 of the Job Creation and Worker Assistance Act of 2002.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

17. Qualified New York Liberty Zone leasehold improvement election out (sec. 709(c) of the Senate amendment)

Present Law

Qualified New York Liberty Zone leasehold improvements placed in service after September 10, 2001 and before January 1, 2007 are depreciable over five years (rather than 39 years) using the straight line method of depreciation. There is no election out of this provision.

Liberty Zone leasehold improvements that are eligible for a five-year recovery period are not also eligible for the 30-percent first-year bonus depreciation under section 168(k) or 1400L(b). A taxpayer may elect out of bonus depreciation. The election out is made at the property class level. Section 168(k)(2)(C)(iii) provides that the election applies to all property in

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[303] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[304] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

the class or classes for which the election out is made that is placed in service for the tax year of the election.

House Bill[305]

No provision.

Senate Amendment[306]

The Senate amendment permits a taxpayer to elect out of the five-year recovery period for qualified New York Liberty Zone leasehold improvement property under rules similar to section 168(k)(2)(C)(iii).

Effective date.–The Senate amendment is effective as if included in the amendments made by section 301 of the Job Creation and Worker Assistance Act of 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

18. Disclosures relating to terrorist activities (sec. 416 of the House bill and sec. 6103 of the Code)

Present Law

In connection with terrorist activities, the IRS is permitted to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request. The Code requires the request to be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. Disclosure of the information is permitted to officers and employees of the Federal law enforcement agency who are personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.[307] A taxpayer's identity is not treated as taxpayer return information for purposes of disclosures to law enforcement agencies regarding terrorist activities.

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[305] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[306] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

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

The Code permits the head of the Federal law enforcement agency to redisclose the information to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency is required to be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.[308]

The Code also allows the IRS to disclose return information (other than taxpayer return information) upon the written request of an officer or employee of the Department of Justice or Treasury who is appointed by the President with the advice and consent of the Senate, or who is the Director of the U.S. Secret Service, if such individual is responsible for the collection and analysis of intelligence and counterintelligence concerning any terrorist incident, threat, or activity.[309] Taxpayer identity information for this purpose is not considered taxpayer return information. Such written request is required to set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. Disclosures under this authority are permitted to be made to those officers and employees of the Department of Justice, Treasury, and Federal intelligence agencies who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence information or investigation concerning any terrorist incident, threat, or activity. Such disclosures are permitted solely for the use of such officers and employees in such investigation, collection, or analysis.

The IRS, on its own initiative, is permitted to disclose in writing return information (other than taxpayer return information) that may be related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate investigating Federal law enforcement agency.[310] Taxpayer identity information for this purpose is not considered taxpayer return information. The head of the agency is permitted to redisclose such information to officers and employees of such agency to the extent necessary to investigate or respond to the terrorist incident, threat, or activity.

If taxpayer return information is sought, the disclosure is required to be made pursuant to the *ex parte* order of a Federal district court judge or magistrate.

No disclosures may be made under these provisions after December 31, 2005.

House Bill[311]

The House bill provision extends all disclosure authority relating to terrorist activities through December 31, 2005. The House bill provision permits the disclosure of taxpayer

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

[309] Sec. 6103(i)(7)(B).

[310] Sec. 6103(i)(3)(C).

[311] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

identity upon receiving a proper written request from the head of a Federal law enforcement agency.

Effective date.–The House bill generally applies to disclosures made on or after the date of enactment. The provision permitting the disclosure of taxpayer identity upon receiving a proper written request from the head of a Federal law enforcement agency is effective as if included in section 201 of the Victims of Terrorism Tax Relief Act of 2001.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

19. Disclosure of return information relating to student loans (sec. 417 of the House bill, sec. 718 of the Senate amendment, and sec. 6103(l) of the Code)

Present Law

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[312] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[313] The Department of Education disclosure authority is scheduled to expire after December 31, 2005.[314]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[315] Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather

[312] Sec. 6103.

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

[314] Pub. L. No. 108-311 (2004).

[315] Sec. 6103(c).

than under the specific exception.[316] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[317]

House Bill[318]

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

Effective date.–The provision is effective on the date of enactment.

Senate Amendment[319]

Same as the House bill.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

20. Extension of cover over of excise tax on distilled spirits to Puerto Rico and Virgin Islands (sec. 418 of the House bill, sec. 705 of the Senate amendment, and sec. 7652 of the Code)

Present Law

A $13.50 per proof gallon (a proof gallon is a liquid gallon consisting of 50 percent alcohol) excise tax is imposed on distilled spirits produced in or imported into the United States.

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported into the United States, without regard to the country of

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

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

[318] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311(the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[319] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

origin. The amount of the cover over is limited under section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2003).

Thus, tax amounts attributable to rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula. All of the amounts covered over are subject to the limitation.

Section 305 of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004") temporarily suspended the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. That law extended the cover over amount of $13.25 per proof gallon for rum brought into the United States after December 31, 2003, and before January 1, 2006. After December 31, 2005, the cover over amount reverts to $10.50 per proof gallon.

House Bill[320]

The provision temporarily suspends the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over amount of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2003, and before January 1, 2006. After December 31, 2005, the cover over amount reverts to $10.50 per proof gallon.

Effective date.–The provision applies to articles brought into the United States after December 31, 2003.

Senate Amendment[321]

Same as the House bill.

Conference Agreement

The conference agreement does not include the House bill and the Senate amendment provision.

21. Joint review of strategic plans and budget for the IRS (sec. 419 of the House bill and secs. 8021 and 8022 of the Code)

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[320] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[321] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Present Law

The Joint Committee on Taxation is required to conduct a joint review[322] of the strategic plans and budget of the IRS from 1999 through 2004.[323] The joint review required in 2004 is considered as timely if conducted before June 1, 2005. The Joint Committee was required to provide an annual report[324] from 1999 through 2003 with respect to:

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

With respect to the annual report for the joint review required in 2004, the report must cover the matters addressed in the joint review.

House Bill[325]

The Joint Committee on Taxation is required to conduct a joint review before June 1, 2005, and to provide an annual report with respect to such joint review. The content of the annual report is the matters addressed in the joint review.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

No provision.

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

[323] Sec. 8021(f).

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

[325] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

Conference Agreement

The conference agreement does not include the House bill provision.

22. Extension of parity in the application of certain limits to mental health benefits (sec. 420 of the House bill, sec. 701 of the Senate amendment, sec. 9812 of the Code, sec. 712 of ERISA, and section 2705 of the PHSA)

Present Law

The Mental Health Parity Act of 1996 amended the Employee Retirement Income Security Act of 1974 ("ERISA") and the Public Health Service Act ("PHSA") to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period. Since enactment, the mental health parity requirements in ERISA and the PHSA have been extended on more than one occasion and were most recently extended to apply with respect to benefits for services furnished before January 1, 2006, by the Working Families Tax Relief Act of 2004 ("WFTRA").[326]

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

The mental health parity requirements in the Code were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period. Since enactment, the mental health parity requirements in the Code have been extended on more than one occasion and were most recently extended to apply with respect to benefits for services furnished before January 1, 2006, by the WFTRA.

House Bill[327]

The House bill extends the Code provisions relating to mental health parity to benefits for services furnished on or after the date of enactment and before January 1, 2006. The excise tax

[326] Pub. L. No. 108-311 (2004).

[327] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

on failures to meet the requirements imposed by the Code provisions does not apply after December 31, 2003, and before the date of enactment.

Effective date.–The provision is effective for benefits for services furnished on or after December 31, 2003.

Senate Amendment[328]

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

Effective date.–The Senate amendment provision extending the Code provision applies to benefits for services furnished on or after December 31, 2003. The ERISA and PHSA provisions apply to benefits for services furnished on or after December 31, 2004.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

23. Combined employment tax reporting (sec. 421 of the House bill and sec. 712 of the Senate amendment)

Present Law

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

The Taxpayer Relief Act of 1997 permits implementation of a limited demonstration project to assess the feasibility and desirability of expanding combined Federal and State reporting. As enacted, it was limited to the sharing of information between the State of Montana and the IRS, but any State may participate in a combined reporting program under present law. However, the project is limited to employment tax reporting. In addition, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer. The authority for the demonstration project expired on the date five years after the date of enactment (August 5, 2002).

[328] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

The Working Families Tax Relief Act of 2004 expanded to all States the authority to participate in a combined Federal and State employment tax reporting program. The authority for this expanded program expires December 31, 2005.

House Bill[329]

The House bill provision extends the demonstration project through December 31, 2005.

Effective date.–The House bill provision takes effect on the date of enactment.

Senate Amendment[330]

The Senate amendment provides permanent authority for any State to participate in a combined Federal and State employment tax reporting program, provided that the program has been approved by the Secretary.

Effective date.–The Senate amendment takes effect on the date of enactment.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

24. Deduction for qualified clean-fuel vehicle property (sec. 422 of the House bill, sec. 721 of the Senate amendment, and sec. 179 of the Code)

Present Law

Certain costs of qualified clean-fuel vehicles may be expensed and deducted when such property is placed in service. 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. The deduction is one quarter of the otherwise allowable amount in 2006, and is unavailable for purchases after December 31, 2006.

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[329] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[330] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

House Bill[331]

The House bill repeals the phase down of the allowable deduction for clean-fuel vehicles in 2004 and 2005. Thus, a taxpayer who purchases a qualifying vehicle may claim 100 percent of the otherwise allowable deduction for vehicles purchased in 2004 and 2005. For vehicles purchased in 2006 the deduction remains at 25 percent of the otherwise allowable amount as under present law.

Effective date.–The provision is effective for vehicles placed in service after December 31, 2003.

Senate Amendment[332]

The Senate amendment repeals the phase down for each of 2004, 2005, and 2006.

(Other sections of the Senate amendment create new credits for the purchase of certain vehicles that would be qualified clean-fuel vehicles under present law. These modifications are not described in this document.)

Effective date.–The provision is effective for vehicles placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

25. Credit for qualified electric vehicles (sec. 422 of the House bill, sec. 720 of the Senate amendment, and sec. 30 of the Code)

Present Law

A ten-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle generally 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 full amount of the credit is available for purchases prior to 2006. The credit is reduced for purchases in 2006, and is unavailable for purchases after December 31, 2006.

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[331] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[332] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

House Bill[333]

The House bill repeals the phase down of allowable tax credit for electric vehicles in 2004 and 2005. Thus, a taxpayer who purchases a qualifying vehicle may claim 100 percent of the otherwise allowable credit for vehicles purchased in 2004 and 2005. For vehicles purchased in 2006 the credit remains at 25 percent of the otherwise allowable amount as under present law.

Effective date.–The provision is effective for vehicles placed in service after December 31, 2003.

Senate Amendment[334]

The Senate amendment repeals the phase down for each of 2004, 2005, and 2006.

(Other sections of the Senate amendment modify the credit. These modifications are not described in this document.)

Effective date.–The provision is effective for vehicles placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the House bill or the Senate amendment provision.

26. Repeal of reduction of deductions for mutual life insurance companies (sec. 710 of the Senate amendment and sec. 809 of the Code)

Present Law

The Pension Funding Equity Act of 2004[335] repealed the rule requiring reduction in certain deductions of a mutual life insurance company (sec. 809), effective for taxable years beginning after 2004.

For taxable years beginning in 2004, under section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its

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[333] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[334] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[335] Pub. L. No. 108-218

deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

For taxable years beginning in 2001, 2002, or 2003, the differential earnings amount is treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount (true-up).

House Bill

No provision.

Senate Amendment

The provision repeals the rule requiring reduction in certain deductions of a mutual life insurance company (sec. 809) for taxable years beginning in 2004.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

27. Study of earnings stripping provisions (sec. 163(j) of the Code)

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through certain earnings stripping transactions. These rules limit the deductibility of interest paid to certain related parties ("disqualified interest"), if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disqualified interest for these purposes also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement requires the Treasury Department to conduct a study of the earnings stripping rules, including a study of the effectiveness of these rules in preventing the shifting of income outside the United States, whether any deficiencies in these rules have the effect of placing U.S.-based businesses at a competitive disadvantage relative to foreign-based businesses, the impact of earnings stripping activities on the U.S. tax base, whether laws of foreign countries facilitate the stripping of earnings out of the United States, and whether changes to the earnings stripping rules would affect jobs in the United States. This study is to include specific recommendations for improving these rules and is to be submitted to the Congress not later than June 30, 2005.

Effective date.–The provision is effective on the date of enactment.

TITLE V – DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

A. Deduction of State and Local General Sales Taxes (sec. 501 of the House bill and sec. 164 of the Code)

Present Law

An itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. No itemized deduction is permitted for State or local general sales taxes.

House Bill

The provision provides that, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. The allowable deduction would be determined under tables prescribed by the Secretary. The tables would be based on the average consumption of taxpayers on a State-by-State basis, and would take into account filing status, number of dependents, adjusted gross income, and rates of State and local general sales taxes.

The term ‘general sales tax’ means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complimentary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003, and prior to January 1, 2006.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with the following modification.

Rather than requiring that taxpayers use tables prescribed by the Secretary to determine their allowable sales tax deduction, taxpayers would instead have two options with respect to the determination of the sales tax deduction amount. Taxpayers would be able to deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury. The tables are to be based on average consumption by taxpayers on a State-by-State basis taking into account filing status, number of dependents, adjusted gross income and rates of State and local general sales taxation. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables would not be reflected in the tables themselves.

The IRS is currently in the process of finalizing tax forms for 2004. The Code has not contained an itemized deduction for State and local sales taxes for a number of years. Developing the tables required by the provision will in general require a significant amount of time and effort. The conferees anticipate that IRS will do the best they can to reasonably and accurately implement this statutory provision in order to effectuate the deduction for the 2005 filing season.

TITLE VI – FAIR AND EQUITABLE TOBACCO REFORM

A. Tobacco Reform
(secs. 701-725 of the House bill and title XI of the Senate amendment)

Present Law

The current tobacco program has two main components: a supply management component and a price support component. In addition, in 1982, Congress passed the "No-Net-Cost Tobacco Program Act"[336] that assured the tobacco program would run at no-net cost to the Federal government.

Supply management

The supply management component limits and stabilizes the quantity of tobacco marketed by farmers. This is achieved through marketing quotas. The Secretary of Agriculture raises or lowers the national marketing quota on an annual basis. The Secretary establishes the national marketing quota for each type of tobacco based upon domestic and export demand, but at a price above the government support price. The purpose of matching supply with demand is to keep the price of tobacco high. There is a secondary market in tobacco quota. Tobacco growers who do not have sufficient quota may purchase or rent one.

Support price

Given the numerous variables that affect tobacco supply and demand, marketing quotas alone have not always been able to guarantee tobacco prices. Therefore, in addition to marketing quotas, Federal support prices are established and guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the Department of Agriculture using the formula specified in the law to calculate loan levels. This system guarantees minimum prices for the different types of tobacco.

The national loan price on 2004 crop flue-cured tobacco is $1.69 per pound; the burley loan price is $1.873 per pound.

No-net-cost assessment

In 1982, Congress passed the "No-Net-Cost Tobacco Program Act." The purpose of this program is to ensure that the nonrecourse loan program is run at no-net-cost to the Federal government.

When tobacco is not contracted, it is sold at an auction sale barn. At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. When the bid does not exceed this price, the farmer may choose to be

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[336] Pub. L. No. 97-218 (1982).

paid the loan price by a cooperative, with money borrowed from the Commodity Credit Corporation ("CCC"). In such cases, the tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for the CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest. If the cooperative does not recover the cost of the loan plus interest, the Secretary of Agriculture assesses growers, purchasers and importers of tobacco in order to repay the difference. All growers, purchasers and importers of tobacco participate in paying these assessments, regardless of whether or not they participate in the loan program.

The no-net-cost assessment on 2004 crop flue-cured is $0.10 per pound; the burley assessment is $0.02 per pound. The no-net-cost assessment funds are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations.

Currently, over 80 percent of growers market their tobacco through contracts with tobacco companies, and thus these growers do not participate in the loan program. However, they must still pay the no-net-cost assessment when the Secretary levies it. The remaining 20 percent of growers market their tobacco through the auction system, and are eligible for participation in the loan program. Of this group, over 60 percent have consistently participated in the loan program during the past several years.

House Bill

The House bill repeals the Federal tobacco support program, including marketing quotas and nonrecourse marketing loans. The House bill also provides quota holders $7.00 per pound based on their 2002 quota allotment paid in equal installments over five years. Additionally, the House bill provides producers transition payments of $3.00 per pound based on their 2002 quota levels paid in equal installments over five years. The House bill caps payments to quota holders and growers at $9.6 billion over fiscal years 2005 through 2009. The House bill applies to the 2005 and subsequent crops of tobacco.

Effective date.–The House bill is effective on the date of enactment.

Senate Amendment

The Senate amendment ends the current Federal tobacco program. The Senate amendment also provides quota holders $8.00 per pound based on their 2002 quota levels paid over a 10-year period. Additionally, the Senate amendment provides tobacco growers with of $4.00 per pound based on their 2002 quota levels, paid over a 10-year period. The payments are funded by assessments on tobacco companies. The Senate amendment also restricts tobacco production to traditional tobacco producing counties and provides poundage and acreage limitations on how much tobacco can be produced in the future as determined by production boards for each type of tobacco. The Senate amendment applies to the 2004 and subsequent crops of tobacco.

Additionally, the Senate amendment gives the Food and Drug Administration regulatory authority over the content and marketing of tobacco products.

Effective date.–The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement repeals all aspects of the Federal tobacco support program, including marketing quotas and nonrecourse marketing loans. The conference agreement provides eligible quota holders $7 per pound on their basic quota allotment paid in equal installments over 10 years. Additionally, the conference agreement provides eligible producers transition payments of $3 per pound based on their effective quota paid in equal installments over 10 years.

The Managers intend the payments to producers and quota holders to be made as quickly and effectively as possible. The Managers expect the Secretary to evaluate and consider the utilization of the proven financial and administrative expertise of the Phase II settlement system to achieve effective and prompt payment. The Managers further expect the Secretary to use the facilities of the Farm Service Agency to furnish information relating to accelerated payment options offered by financial institutions.

Manufacturers and importers of tobacco products will pay a quarterly assessment into a newly formed Tobacco Trust Fund. These assessments will be on the following classes of tobacco: Cigarettes, Snuff, Chewing Tobacco, Pipe Tobacco, Roll-your-own tobacco, and Cigars. Assessment allocations will then be divided into manufacturers' and importers' market share. Funds from the Tobacco Trust Fund will be used to provide payments to quota holders and eligible producers as well as pay for program losses incurred by the U.S. Department of Agriculture.

The conference agreement applies to the 2005 and subsequent crops of tobacco.

Effective date.–The conference agreement is effective on the date of enactment.

TITLE VII - PROTECTION OF UNITED STATES WORKERS FROM COMPETITION OF FOREIGN WORKFORCES

THE SENATE AMENDMENT CONTAINED A PROVISION RELATING TO PROTECTION OF UNITED STATES WORKERS FROM COMPETITION OF FOREIGN WORKFORCES. THE CONFERENCE AGREEMENT DOES NOT INCLUDE THE SENATE AMENDMENT PROVISION.

TITLE VIII – OTHER PROVISIONS

A. Provisions Relating to Housing

1. Treatment of qualified mortgage revenue bonds (sec. 601 of the Senate amendment and sec. 143 of the Code)

Present Law

Under present law, qualified mortgage bonds are tax-exempt bonds used to finance owner-occupied residences. Among other requirements, these bonds are subject to income and purchase price limitations, as well as a requirement that the homebuyer not have an ownership interest in the principal residence in the preceding three years.

Generally, in order for a bond to be a qualified mortgage bond, the mortgagor's family income cannot exceed 115 percent of the applicable median family income. Adjustments are made for targeted area residences, for areas that have high housing costs in relation to income, and for family size. Further, 95 percent or more of the net proceeds of qualified mortgage bonds must be used to finance residences for first-time homebuyers. Exceptions are made for financing of targeted area residences, qualified home improvement loans, and qualified rehabilitation loans.

A residence financed with a mortgage funded by qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. Adjustments are made for residences located in certain low-income or economically distressed areas, and for the number of families for which a residence is designed.

Part or all of the interest subsidy provided by qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase. The annual volume limitations imposed on most qualified private activity bonds limits the aggregate face amount of qualified mortgage bonds that may be issued. In addition, repayments of mortgage principal received after 10 years from the date of issue must be used to retire outstanding bonds (the "10-year rule").

House Bill

No provision.

Senate Amendment

The Senate amendment suspends the 10-year rule for one year for outstanding bonds, allowing repayments of principal received during this period to be used to finance new mortgage loans rather than retiring outstanding bonds. The Senate amendment repeals the 10-year rule for bonds originally issued after the date of enactment.

<u>Effective date</u>.–The provision repeals the 10-year rule for bonds issued after the date of enactment and suspends the 10-year rule for outstanding bonds for a one-year period beginning on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Premiums for mortgage insurance (sec. 602 of the Senate amendment and secs. 163(h) and 6050H of the Code)

Present Law

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is $100,000. The maximum amount of acquisition indebtedness is $1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means the Home Loan Guaranty Program of the Department of Veterans Affairs, and mortgage insurance provided by the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which it is allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

Reporting rules apply under the provision.

Effective date.–The Senate amendment provision is effective for amounts paid or accrued after the date of enactment in taxable years beginning after December 31, 2004, and ending before January 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Increase in historic rehabilitation credit for residential housing for the elderly (sec. 603 of the Senate amendment and secs. 42 and 47 of the Code)

Present Law

Rehabilitation credit

Present law provides a credit for rehabilitation expenditures (sec. 47). A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of the adjusted basis of the building (and its structural components), or $5,000. The taxpayer's depreciable basis in the property is reduced by any rehabilitation credit claimed.

Low-income housing credit

The low-income housing tax credit (sec. 42) may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified expenditures. The aggregate credit authority provided annually to each State is $1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The $1.75 per resident cap is indexed for inflation.

Qualified basis with respect to which the credit may be computed is generally determined as the portion of the eligible basis of the qualified low-income building attributable to the low-income rental units. Qualified basis generally is the taxpayer's depreciable basis in a qualified low-income building. In the case of a taxpayer who claims the rehabilitation credit for a qualified low-income building, the taxpayer's depreciable basis in the building is reduced by the amount of the rehabilitation credit claimed. In addition, eligible basis is reduced by any Federal grant received with respect to the building. A qualified low-income building is a building that meets certain compliance criteria and is depreciable under the modified accelerated cost recovery system ("MACRS").

House Bill

No provision.

Senate Amendment

The Senate amendment increases the present-law 20-percent credit for historic rehabilitation expenses to 25 percent in the case of rehabilitation expenses incurred with respect to a building which is also a low-income housing credit property in which substantially all of the tenants, both those tenants in rent-restricted units and in other residential units, are age 65 or greater. The Senate amendment permits the 25-percent rehabilitation credit to be claimed with respect to all parts of the building, not only those parts on which the taxpayer also claims the low-income housing credit.[337]

Effective date.–The Senate amendment provision is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[337] The Senate amendment also repeals a transition rule to the Tax Reform Act of 1986 permitting the taxpayers who own the property described as the Warrior Hotel, Ltd., the first two floors of the Martin Hotel, and the 105,000 square foot warehouse constructed in 1910, all in Sioux City, Iowa, to use ACRS depreciation, in lieu of MACRS depreciation. This change enables such property to qualify for the provision.

B. Provisions Relating to Bonds

1. Modification of the authority of Indian tribal governments to issue tax-exempt bonds (sec. 613 of the Senate amendment and sec. 7871 of the Code)

Present Law

Under present law, the interest on bonds issued by an Indian tribal government is tax-exempt if substantially all of the proceeds of are to be used in the exercise of an essential government function. The term essential government function does not include any function that is not customarily performed by State or local governments with general taxing powers. In addition, Indian tribal governments are prohibited from issuing private activity bonds, with the exception of bonds issued to finance certain manufacturing facilities.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the tax-exemption for Indian tribal government bonds to include obligations 95 percent or more of the proceeds of which are used to finance any facility located on an Indian reservation. The tax-exemption does not include any obligations used to finance any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted or housed.

For purposes of the Senate amendment, an Indian reservation means: (1) a reservation as defined in section 4(10) of the Indian Child Welfare Act of 1978, and (2) lands held under the provisions of the Alaska Native Claims Settlement Act by a Native corporation as defined in section 3(m) of that Act.

Effective date.–The provision is effective for bonds issued after the date of enactment and before January 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Definition of manufacturing facility for qualified small issue bonds (sec. 614 of the Senate amendment and sec. 144 of the Code)

Present Law

Qualified small-issue bonds are bonds used to finance private business manufacturing facilities or the acquisition of land and equipment by certain farmers. Generally, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) in the same municipality or county. This $1 million limit may be increased to $10 million if all other capital expenditures of the business (including related parties) in the same municipality or county over a six-year period are counted toward the limit. In addition, 95 percent or more of the net proceeds of qualified small-issue bonds must be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or to redeem a prior issue that was used for those purposes.

Under present law, a manufacturing facility is defined as any facility used in the manufacturing or production of tangible personal property. Facilities that are directly related and ancillary to a manufacturing facility may be financed with small-issue bonds if such facilities are located on the same site as the manufacturing facility and no more than 25 percent of the net proceeds of the bonds are used to finance such facilities.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the definition of manufacturing facilities eligible for small-issue bond financing to include facilities: (1) used in the manufacture or development of software products or processes, if it takes more than six months to manufacture or develop such products or processes, such manufacture or development could not with due diligence be reasonably expected to occur in less than six months, and the software product or process comprises programs, routines, and attendant documentation developed and maintained for use in computer and telecommunications technology; and (2) used in the manufacture or development of any biobased product or bioenergy, if it takes more than six months to manufacture or develop and the manufacture or development could not with due diligence be reasonably expected to occur in less than six months. The term biobased product means a commercial or industrial product which utilizes biological products or renewable domestic agricultural or forestry materials. The term bioenergy means biomass used in the production of energy, including liquid, solid, or gaseous fuels, electricity, and heat.

The Senate amendment expands the definition of eligible facilities to include directly and functionally related offices and research and development facilities located on the same site as the manufacturing facilities. Such office and research and development facilities may not constitute more than 40 percent of the net proceeds of the issue used to finance the facility.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Qualified forest conservation bonds (sec. 615 of the Senate amendment and sec. 142 of the Code)

Present Law

Tax-exempt bonds

In general

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

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Generally, interest on bonds issued to benefit section 501(c)(3) organizations is tax-exempt ("qualified 501(c)(3) bonds"). In addition, States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, hazardous waste disposal facilities and public educational facilities); privately owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas.

Tax-exempt private activity bonds are subject to restrictions that generally do not apply to other bonds issued by State or local governments. In most cases, the aggregate face amount of tax-exempt private activity bonds that may be issued is restricted by annual volume limits. Moreover, most tax-exempt private activity bonds are subject to a term-to-maturity rule. Under that rule, the average maturity of most tax-exempt private activity bond cannot exceed 120 percent of the economic life of the property being financed.

Section 501(c)(3) organizations generally may not obtain the benefits of exempt facility bonds for debt issued and used to acquire forests and forest lands. In addition, qualified 501(c)(3) bonds may not be issued to acquire forests and forest lands to the extent such lands are used to finance a trade or business that is unrelated to the exempt purposes of the organization. Whether income derived by a section 501(c)(3) organization from timber harvesting is unrelated trade or business income depends upon a variety of factors.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that qualified forest conservation bonds are treated as exempt facility bonds. Qualified forest conservation bonds are bonds issued for a qualified organization if 95 percent or more of the net proceeds of such bonds are used for qualified project costs, including acquisition of forests and forest land, capitalized interest, and credit enhancement fees that constitute qualified guarantee fees (within the meaning of section 148 of the Code). The costs of acquiring forests and forest land are qualified project costs if such land is acquired by a qualified organization from an unrelated party and at the time of acquisition or immediately thereafter such land is subject to a conservation restriction. Among other requirements, a qualified organization must be a nonprofit organization more than half the value of which consists of forests and forest land acquired with the proceeds of qualified forest conservation bonds.

The volume limitation on tax-exempt private activity bonds does not apply to qualified forest conservation bonds. Rather, the maximum aggregate face amount of qualified forest conservation bonds that may be issued is $1.5 billion, to be allocated by the Secretary of Treasury among qualified organizations. For purposes of the term-to-maturity rule, the land and timber acquired with qualified forest conservation bonds shall have an economic life of 35 years.

The Senate amendment provides that certain timber harvesting income derived by a qualified organization from forest lands acquired with proceeds from the qualified forest conservation bonds is excludable from income to the extent such income is used to pay debt service on the bonds and satisfies other conservation restrictions.

Effective date.–The provision is effective for bonds issued on or after the date that is 180 days after the date of enactment and before December 31, 2006.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

4. Qualified tribal school modernization bonds (sec. 616 of the Senate amendment)

Present Law

Under present law, the interest on bonds issued by an Indian tribal government is tax-exempt if substantially all of the proceeds of are to be used in the exercise of an essential government function. The term essential government function does not include any function that is not customarily performed by State or local governments with general taxing powers. In addition, Indian tribal governments are prohibited from issuing private activity bonds, with the exception of bonds issued for certain manufacturing facilities.

There is no present law provision that permits Indian tribal governments to issue tax-credit bonds.

House Bill

No provision.

Senate Amendment

The Senate amendment authorizes the Secretary of the Interior to establish a program under which eligible Indian tribes may issue qualified tribal school modernization bonds ("tribal school bonds"). A tribal school bond means any bond issued under the program if: (1) 95 percent of the proceeds of the issue are used for the construction, rehabilitation, or repair of a school facility funded by the Bureau of Indian Affairs of the Department of the Interior or for the acquisition of land on which such a school facility is to be constructed; (2) the bond is issued by an Indian tribe; (3) the issuer designates the bond for purposes of the program; and (4) the term of each bond that is part of such an issue does not exceed 15 years. For purposes of the provision, the term Indian tribe has the same meaning as the term Indian tribal government under section 7701(a)(40) of the Code (including the application of section 7871(d)) and any consortium of tribes approved by the Secretary of the Interior.

Under the provision, the holder of a tribal school bond receives a nonrefundable tax credit, in lieu of interest. The amount of the credit allowed is included in the holder's gross income as interest income. Unused credits may be carried forward to the succeeding taxable year.

The Senate amendment authorizes the Secretary of the Interior to establish an escrow fund to secure repayment of tribal school bonds. Principal payments on tribal school bonds may only be made from amounts in the escrow fund and such bonds are not guaranteed by the United States, the issuing Indian tribe, or the tribal school for which the bond was issued.

The Senate amendment establishes a national limitation of $200 million on the amount of tribal school bonds that may be designated in each of the years 2005 and 2006. The authority to issue tribal school bonds shall be allocated to Indian tribes by the Secretary of the Interior.

Effective date.–The provision is effective on the date of enactment with respect to bonds issued after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Provisions Relating to Depreciation

1. 7-year recovery period for certain track facilities (sec. 623 of the Senate amendment and sec. 168 of the Code)

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a statutory 7-year recovery period for permanent motorsports racetrack complexes. For this purpose, motorsports racetrack complexes include land improvements and support facilities but do not include transportation equipment, warehouses, administrative buildings, hotels, or motels.

Effective date.–The Senate amendment is effective for property placed in service after date of enactment and before January 1, 2008. No inference is intended with respect to the treatment of expenses incurred prior to the effective date.

Conference Agreement

The conference agreement follows the Senate amendment with the following modification to the effective date provisions.

Effective date.–The conference agreement is effective for property placed in service after the date of enactment and before January 1, 2008. The conference agreement also excludes racetrack facilities placed in service after the date of enactment from the definition of theme and amusement facilities classified under Asset Class 80.0. The conferees do not intend for this provision to create any inference as to the treatment of property placed in service on or before the date of enactment. Accordingly, the conferees do not intend for the provision to affect the interpretation of the scope of Asset Class 80.0 for assets placed in service prior to the date of enactment. The conferees strongly urge the Secretary to resolve expeditiously any taxpayer disputes with respect to the scope of Class 80.0.

2. Alternative minimum tax and credits (sec. 624 of the Senate amendment and secs. 38 and 53 of the Code)

Present Law

Election to Increase Minimum Tax Credit Limitation in Lieu of Bonus Depreciation

Under present law, corporations are entitled to a minimum tax credit for the minimum tax imposed in prior taxable years. The amount of the credit is limited to the excess of the taxpayer's regular tax over the tentative minimum tax ("minimum tax credit limitation").

Under present law, certain property is allowed an additional depreciation allowance for the taxable year placed in service. This additional allowance is known as "bonus depreciation". Bonus depreciation is a temporary provision.

Use of General Business Credits Against the Alternative Minimum Tax

Under present law, the general business credit for any taxable year is limited to the excess of the taxpayer's income tax over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000).[338]

House Bill

No provision.

Senate Amendment

Election to Increase Minimum Tax Credit Limitation in Lieu of Bonus Depreciation

The Senate amendment provides an election by a corporation to increase its minimum tax credit limitation for a taxable year by one half of the bonus depreciation amount. If a corporation makes an election for any taxable year, no bonus depreciation is allowed with respect to any property placed in service by the corporation for the taxable year. The bonus depreciation amount for a taxable year is an amount (not in excess of $25 million) equal to 30 percent of the aggregate bonus depreciation that would have been allowable but for the election. Any minimum tax credit allowable by reason of the election may be refundable to the extent it exceeds the corporation's tax liability.

Effective date.–Taxable years ending after December 31, 2003.

[338] Special rules apply to the empowerment zone employment credit and the New York Liberty Zone business credit.

Use of General Business Credits Against the Alternative Minimum Tax

The Senate amendment provides that the general business credit for any taxable year beginning in 2004 shall not be less than 50 percent of the lesser of (1) the amount of credit that would be allowed if the tentative minimum tax were zero for the taxable year or (2) the current year business credit. In no event shall the credit be less than the amount otherwise allowable under present law.

Effective date.–Taxable years beginning in 2004.

Conference Agreement

The conference agreement does not include the provisions in the Senate amendment.

D. Expansion of Business Credit

1. New markets tax credit for Native American reservations (sec. 631 of the Senate amendment)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[339] The amount of the credit allowed to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit on each anniversary date thereafter for the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary dates. The credit is recaptured if at any time during the seven-year period that begins on the date of the initial issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the interest is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board or any advisory board of the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock or a similar equity interest acquired directly from a CDE for cash. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is defined as a census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). The Secretary may designate any area within any census tract as a low-income community provided that (1) the boundary is continuous, (2) the area (if it were a census tract) would otherwise satisfy the poverty rate or median income requirements, and (3) an inadequate access to investment capital exists in the area.

[339] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

A qualified active business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and $3.5 billion per year for calendar years 2006 and 2007.

No special rules apply to investments in community development entities that serve or provide investment capital with respect to low-income Native American reservations.

House Bill

No provision.

Senate Amendment

The Senate amendment provides special new markets tax credit rules for qualified equity investments in a "reservation development entity." In general, the present-law requirements applicable to the new markets tax credit apply for purposes of the new credit, with special requirements established to define the qualified investment entity (i.e., for purposes of this credit, the present-law "community development entity" is replaced with "reservation development entity"). Under the Senate amendment, a reservation development entity is a domestic corporation or partnership if: (A) the primary mission of the entity is serving, or providing investment capital for, low-income reservations; (B) the entity maintains accountability to residents of low-income reservations through their representation on any governing board or any advisory board of the entity; and (C) the entity is certified by the Secretary as being a reservation development entity. A low-income reservation means an Indian reservation (as defined in section 168(j)(6)) that has a poverty rate of at least 40 percent.

The maximum annual amount of qualified equity investments in reservation development entities is $50 million for each of calendar years 2004 through 2007. The limitation shall be allocated by the Secretary among reservation development entities selected by the Secretary, giving priority to any entity with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities, or that intends to make qualified low-income reservation investments in one or more unrelated businesses.

The Senate amendment provides that not later than January 31 of 2007 and 2010, the Comptroller General of the United States shall, pursuant to an audit, report to Congress on the new credit program, including all reservation development entities that receive an allocation under the program. In addition, the Senate amendment authorizes the Secretary to award a grant of not more than one million dollars to the First Nations Oweesta Corporation, and authorizes appropriations of one million dollars for fiscal years 2004 through 2014.

Effective date.–The provision is effective for investments made after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment.

2. Ready Reserve-National Guard employee credit and Ready Reserve-National Guard replacement employee credit (sec. 632 of the Senate amendment)

Present Law

There is no employer tax credit for wages paid to Ready Reserve and National Guard employees called to active duty, or for wages paid to their replacements.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an employer credit for wages paid to Ready Reserve-National Guard employees called to active duty. A Ready Reserve-National Guard employee means an employee who is a member of the Ready Reserve of a reserve component of an Armed Force of the United States as described in sections 10142 and 10101 of title 10, United States Code. The credit equals 50 percent of the compensation paid while the employee is called up to active duty up to a maximum of $30,000 of compensation. Special rules allowing refundability of the credit, up to the amount of employer payroll taxes, apply to employers of first responders called up to active duty. Qualified first responders are persons employed as a law enforcement official, a firefighter, or a paramedic, and who are a Ready Reserve-National Guard employee.

In addition, for "small business employers" of Ready Reserve-National Guard employees called up to active duty, the Senate amendment creates a replacement employee credit equal to 50 percent of the wages paid to any replacement employee up to a maximum credit of $6,000. Small business employers are employers that employ an average of 50 or fewer employees on business days during the taxable year. For small business manufacturing employers, the credit rate is increased to 100 percent and the maximum credit is increased to $20,000.

Self-employed contract workers called to active duty are eligible for the self employed portion of the credit, but businesses purchasing the services of contract workers are not eligible for the replacement employee credit.

The credits could be carried back 3 years and carried forward 20 years. Rules similar to section 280C apply to deny a deduction for the amount of the credits.

Effective date.–The provision is effective for investments made after September 30, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment.

3. Rural investment tax credit (sec. 633 of the Senate amendment and new sec. 42A of the Code)

Present Law

There is no present-law provision specifically targeted to encourage investment in high-migration rural areas.

House Bill

No provision.

Senate Amendment

The proposal provides a tax credit that may be claimed by owners of certain rural residential property (i.e., qualified rural investment buildings). The credit is claimed annually, generally for a period of ten years. Taxpayers are eligible for a maximum present-value tax credit equal to 70 percent of the eligible basis of a new building and qualified rehabilitation expenses (30 percent in the case of an existing building).

A qualified rural investment building is defined as any building that is part of a qualified rural investment project at all times during the credit period. A qualified rural investment project is defined as any investment project of one or more buildings; (1) located in a qualifying county (and, if necessary to the project, a contiguous county); and (2) selected by the State in which the county is located, according to the State's qualified rural investment plan. Rehabilitation expenditures are treated as a separate building for purposes of the credit. A qualifying county is defined as a county which: (1) is located outside a metropolitan statistical area (as defined by the Office of Management and Budget); and (2) during the 20-year period ending with the year the most recent census was conducted, has experienced a net out-migration of inhabitants of the county of at least 10-percent of the population of the county. Generally, the credit and compliance periods are each ten years and the credit period for an existing building may not begin before the credit period for the related rehabilitation expenditures.

For purposes of this credit, the eligible basis of any qualified rural investment building shall be determined under rules similar to the rules of section 42 (the "low income rental housing credit") except that: (1) the determination of the adjusted basis of any building shall be made at the beginning of the credit period; and (2) such basis shall include development costs properly attributable to such building. Development costs are limited to: (1) site preparation costs; (2) State and local impact fees; (3) reasonable development fees; (4) professional fees related to basis items; (5) construction financing costs related to basis items other than land; and (6) on-site and adjacent improvements required by State or local governments.

Generally, any building eligible for the credit must receive an allocation of rural investment credit authority from the State rural investment credit agency in whose jurisdiction the building is located. The aggregate amount of such credits allocated within a State is limited by the State's annual rural investment credit ceiling. The ceiling for each calendar year is the sum of: (1) the unused State rural investment credit ceiling (if any) of such State for the preceding calendar year; (2) $185,000 for each qualifying county of the State; (3) the amount of State rural investment credit ceiling returned in the calendar year; and (4) the amount (if any) allocated to the State by the Secretary of the Treasury from the pool of unallocated rural investment credits unused by other States. The allocation is made by a formula provided in the statute. The $185,000 amount is indexed for inflation. At least 10 percent of each State's rural investment credit ceiling is set aside for projects in which a qualified non-profit organization is to materially participate (within the meaning of section 469(h) of the Code) in the development and operation of the project throughout the compliance period. A qualified non-profit organization generally means any organization if: (1) the organization is described in section 501(c) and exempt from tax under 501(a); (2) it is determined by the State rural investment credit agency not to be affiliated with or controlled by a for-profit organization; and (3) one or more of its exempt purposes includes the fostering of rural investment.

Effective date.--The provision is effective for expenditures made in taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate Amendment.

4. Qualified small business rural investment tax credit (sec. 634 of the Senate amendment and new sec. 42B of the Code)

Present Law

There is no present-law provision specifically targeted to encourage rural small business investment.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 30-percent tax credit for certain qualified expenditures paid or incurred by qualified rural small businesses. A qualified taxpayer's maximum credit for any taxable year may not exceed the lesser of: (1) $5,000; or (2) $25,000 minus the sum of the taxpayer's previous qualified rural small business investment credit claimed for all prior taxable years. For purposes of this credit, qualified expenditures are defined as expenditures normally associated with starting or expanding a business and included in a qualified business plan, including costs for capital, plant and equipment, inventory expenses, and wages but not including interest costs. In the case of a qualified rural small business with respect to which a small business rural investment credit was claimed in any previous years, qualified expenditures for each taxable year are limited to qualified small business expenditures for the year only to the extent that those total expenditures exceed the total expenditures for the immediately preceding taxable year. For example, assume Taxpayer A incurs qualified expenditures of $3000, in year 1, $0 in year 2, and $4,000 in year 3. Taxpayer A will be eligible for a qualified rural investment tax credit of $900 in year 1, $0 in year 2, and $1,200 in year 3.

A qualified rural small business is defined as any person, if such person; (1) employed not more than five full-time employees during the taxable year; (2) materially and substantially participates in management; (3) is located in a qualifying county; and (4) submitted a qualified business plan with respect to which an allocation of a rural investment tax credit was received. For these purposes, an employee is considered full-time if such employee is employed at least 30 hours per week for 20 or more calendar weeks in the taxable year. A qualifying county is defined as a county which: (1) is located outside a metropolitan statistical area (as defined by the Office of Management and Budget); and (2) during the 20-year period ending with the year the most recent census was conducted, has experienced a net out-migration of inhabitants of the county of at least 10-percent of the population of the county. A qualified business plan is a business plan which: (1) has been approved by the rural investment credit agency with jurisdiction over the qualifying county in which the qualified rural small business is located pursuant to such agency's rural investment plan; and (2) meets such requirements as the agency may specify.

Any otherwise allowable deduction or credit is reduced by the amount of this credit.

Effective date.–The provision is effective for expenditures made in taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate Amendment.

5. Provide a tax credit for maintenance of railroad track (sec. 635 of the Senate amendment and new sec. 45I of the Code)

Present Law

There is no provision that provides for a railroad track maintenance tax credit.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 30-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred in a taxable year by eligible taxpayers. The credit is limited to the product of $3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer as of the close of its taxable year. Qualified railroad track maintenance expenditures are defined as amounts expended (whether or not chargeable to a capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad. An eligible taxpayer is defined as: (1) any Class II or Class III railroad; and (2) any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to such person. The taxpayer's basis in railroad track is reduced by the amount of the credit allowed. No portion of the credit may be carried back to any taxable year beginning before January 1, 2005. Other rules apply.

This credit applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement follows the Senate amendment provision with the following modification. The conference agreement increases the credit percentage from 30-percent to 50-percent. In addition, the conference agreement clarifies that each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation.

6. Railroad revitalization and security investment credit (sec. 636 of the Senate amendment)

Present Law

There is no provision in present law for railroad revitalization.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 50-percent business tax credit for qualified project expenditures paid or incurred in a taxable year by eligible taxpayers. Qualified project expenditures generally are defined as expenditures (whether or not chargeable to a capital account) for: (1) planning; (2) environmental review and environmental impact mitigation; (3) track and track structure rehabilitation, relocation, improvement and development; (4) railroad safety and security improvements; (5) communications and signaling improvements; (6) intercity passenger rail equipment acquisition; and (7) rail station and intermodal facilities development. Such expenditures are limited to expenditures for a project with respect to intercity passenger rail transportation (as defined in 49 U.S.C. 24102) that is included in a State rail plan.

The railroad revitalization and security investment credit is subject to a national cap of $165 million per calendar year. The annual national cap is allocated pro rata to the States based on the each State's share of the national total of: (1) railroad and public road grade crossings on intercity passenger rail routes; (2) intercity passenger train miles; and (3) intercity embarkations and disembarkations for each passenger. Any credit allocations unused for a calendar year will be carried-over and allocated between those States that used their allocation for the calendar year and requested a share of the carryover. All projects must have an allocation to claim the credit.

The taxpayer's basis in such property is reduced by the amount of the credit allowed. No portion of the credit may be carried back to any taxable year beginning before January 1, 2005. A credit under this section may be transferred (but no more than once) if the taxpayer is a tax-exempt entity or if the credit exceeds the taxpayer's tax liability for the year. Other rules apply.

Effective date.--The Senate amendment is effective for taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Special allocation of the railroad revitalization and security investment credit for New York city rail projects (sec. 636 of the Senate amendment)

Present Law

There is no provision in present law that provides a special allocation of the railroad revitalization and security investment credit.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an additional allocation of $200 million dollars to New York City for qualified project expenditures within the New York Liberty Zone (as defined in Code section 1400L(h). This allocation is in addition to the allocation allowed under the general railroad revitalization and security investment credit, described above. Under a special rule, the $200 million will be allocated as follows: (1) $100 million to projects designated by the mayor of New York City; and (2) $100 million to projects designated by the Governor of New York. Qualified project expenditures are limited to expenditures for improvements to subway systems, for commuter rail systems, for rail links to airports, and for public infrastructure improvements in the vicinity of rail or subway stations. The taxpayer's basis in such property is reduced by the amount of the credit for which this credit is allowed. No portion of the credit may be carried back to any taxable year beginning before January 1, 2005. A credit under this section may be transferred (but no more than once) if the taxpayer is a tax-exempt entity or if the credit exceeds the taxpayer's tax liability for the year. Other rules apply.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Modification of targeted areas and low-income communities designated for new markets tax credit (sec. 637 of the Senate amendment and sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[340] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is defined as a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family

[340] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

income). The Secretary may designate any area within any census tract as a low-income community provided that (1) the boundary is continuous, (2) the area (if it were a census tract) would otherwise satisfy the poverty rate or median income requirements, and (3) an inadequate access to investment capital exists in the area.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the Secretary's authority to designate certain areas as low-income communities to provide that the Secretary shall prescribe regulations to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under the Senate amendment, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[341] Under the Senate amendment, a targeted population is not required to be within any census tract.

Effective date.–The provision is effective for designations made after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with respect to targeted population designations, modified to provide that a population census tract with a population of

[341] 12. U.S.C. 4702(17) (used to define "low-income" for purposes of 12. U.S.C. 4702(20)).

less than 2,000 shall be treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

Effective date.–The targeted population provision is effective for designations made after the date of enactment. The low-population provision is effective for investments made after the date of enactment.

9. Modification of income requirement for census tracts within high migration rural counties for new markets tax credit (sec. 638 of the Senate amendment and sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[342] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for the taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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[342] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

A "low-income community" is defined as a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). The Secretary may designate any area within any census tract as a low-income community provided that (1) the boundary is continuous, (2) the area (if it were a census tract) would otherwise satisfy the poverty rate or median income requirements, and (3) an inadequate access to investment capital exists in the area.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the low-income test for high migration rural counties. Under the Senate amendment, in the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

Effective date.–The provision is effective as if included in the amendment made by section 121(a) of the Community Renewal Tax Relief Act of 2000.

Conference Agreement

The conference agreement follows the Senate amendment.

10. Provide a tax credit for expenditures on closed captioning technology in movies (sec. 639 of the Senate amendment and new sec. 45T of the Code)

Present Law

There is no provision that allows a tax credit for expenditures made for closed captioning technology in motion pictures.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 50-percent business tax credit (the "motion picture accessibility credit") for certain qualified expenditures made in a taxable year by an eligible taxpayer. Qualified expenditures are defined as amounts paid or incurred for making motion pictures accessible to deaf or hard-of-hearing individuals through the use of captioning technology. An eligible taxpayer is defined as a taxpayer who is in the business of showing motion pictures to the public in theaters or producing or distributing those motion pictures. The taxpayer's basis in property with respect to which the credit is allowed is reduced by the amount of the credit allowed. No deduction or credit is permitted under any other provision of Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code for the amount of any motion picture accessibility credit allowed. No portion of the credit may be carried back to any taxable year beginning before January 1, 2004. Other rules apply.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Miscellaneous Provisions

1. Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income (sec. 641 of the Senate amendment and secs. 512 and 514 of the Code)

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2) obligations to pay certain types of annuities; (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment provides an exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, the Senate amendment provides an exception from the debt-financed property rules for such properties.

In order to qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[343]

Qualifying brownfield properties

Under the Senate amendment, the exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (as in effect on the date of enactment of the proposal). The Senate amendment provision requires that the taxpayer's request for certification include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

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[343] For purposes of the provision, a person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[344]

Qualified sale, exchange, or other disposition

Under the Senate amendment, a sale, exchange, or other disposition of a qualifying brownfield property shall be considered as qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer's request for a remediation certification shall be made no later than the date of the transfer and shall include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[345] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially

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[344] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

[345] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

complete, and if substantially complete,[346] sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice shall include, at a minimum, publication in a major local newspaper of general circulation.

A copy of each of the requests for certification that the property was a brownfield site, and that it would no longer be a qualifying brownfield property in the hands of the transferee, shall be included in the tax return of the eligible taxpayer (and, where applicable, of the qualifying partnership) for the taxable year during which the transfer occurs.

Eligible remediation expenditures

Under the Senate amendment, eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[347] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property, or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;[348] (3) any amount

[346] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

[347] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

[348] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability

paid or incurred to the extent such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the proposal.[349]

Qualified gain or loss

The Senate amendment generally excludes from unrelated business taxable income the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property. Income, gain, or loss from other transfers does not qualify under the provision.[350] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. Further, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[351]

Special rules for qualifying partnerships

In general

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the Senate amendment

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coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

[349] The provision authorizes the Secretary of the Treasury to issue guidance regarding the treatment of government-provided funds for purposes of determining eligible remediation expenditures.

[350] For example, rent income from leasing the property does not qualify under the proposal.

[351] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

provision applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the disposition of the property.[352] A qualifying partnership is a partnership that (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the proposal if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.[353]

Under the Senate amendment, the Secretary shall prescribe such regulations as are necessary to prevent abuse of the requirements of the provision, including abuse through the use of special allocations of gains or losses, or changes in ownership of partnership interests held by eligible taxpayers.

Certifications and multiple property elections

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying

[352] The provision's exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by present-law.

[353] The provision subjects a tax-exempt partner to tax on gain previously excluded by the partner (plus interest) if a property subsequently becomes ineligible for exclusion under the qualifying partnership's multiple-property election.

brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[354]

An acquiring taxpayer makes a multiple-property election with its timely filed tax return (including extensions) for the first taxable year for which it intends to have the election apply. A timely filed election is effective as of the first day of the taxable year of the return in which the election is included or a later day in such taxable year selected by the taxpayer. An election remains effective until the earliest of a date selected by the taxpayer, the date which is eight years after the effective date of the election, the effective date of a revocation of the election, or, in the case of a partnership, the date of the termination of the partnership.

A taxpayer may revoke a multiple-property election by filing a statement of revocation with a timely filed tax return (including extensions). A revocation is effective as of the first day of the taxable year of the return in which the revocation is included or a later day in such taxable year selected by the eligible taxpayer or qualifying partnership. Once a taxpayer revokes the election, the taxpayer is ineligible to make another multiple-property election with respect to any qualifying brownfield property subject to the revoked election.[355]

Debt-financed property

The Senate amendment provides that debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the provisions of the proposal that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

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[354] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

[355] The provision subjects a taxpayer to tax on gain previously excluded (plus interest) in the event a site subsequently becomes ineligible for gain exclusion under the multiple-property election.

Effective date.–The Senate amendment provision applies to gain or loss on the sale, exchange, or other disposition of a property acquired by the taxpayer after December 31, 2004.

Conference Agreement

The conference agreement follows the Senate amendment, modified to provide a termination date of December 31, 2009. The conference agreement provision applies to gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009. Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

Effective date.–The conference agreement provision applies to gain or loss on property that is acquired after December 31, 2004.

2. Civil rights tax relief (sec. 643 of the Senate amendment and sec. 62 of the Code)

Present Law

Under present law, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness.[356] Expenses relating to recovering such damages are generally not deductible.[357]

Other damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income,[358] subject to the two-percent floor on itemized deductions.[359] Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount.[360] For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

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[356] Sec. 104(a)(2).

[357] Sec. 265(a)(1).

[358] Sec. 212.

[359] Sec. 67.

[360] Sec. 68.

In some cases, claimants will engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years. Some courts[361] have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney and to the overall limitation on itemized deductions. Other courts have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.[362]

House Bill

No provision.

Senate Amendment

The Senate amendment provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

Under the proposal, "unlawful discrimination" means an act that is unlawful under certain provisions of any of the following: the Civil Rights Act of 1991; the Congressional Accountability Act of 1995; the National Labor Relations Act; the Fair Labor Standards Act of 1938; the Age Discrimination in Employment Act of 1967; the Rehabilitation Act of 1973; the Employee Retirement Income Security Act of 1974; the Education Amendments of 1972; the Employee Polygraph Protection Act of 1988; the Worker Adjustment and Retraining Notification Act; the Family and Medical Leave Act of 1993; chapter 43 of Title 38 of the United States Code; the Revised Statutes; the Civil Rights Act of 1964; the Fair Housing Act; the Americans with Disabilities Act of 1990; any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law; or any provision of Federal, State or local law, or common law claims permitted under Federal, State, or local law providing

[361] *Kenseth v. Commissioner*, 114 T.C. 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

[362] *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Arthur Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). In some of these cases, such as *Cotnam*, State law has been an important consideration in determining that the claimant has no claim of right to the recovery.

for the enforcement of civil rights or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Effective date.–The Senate amendment provision applies to fees and costs paid after December 31, 2002, with respect to any judgment or settlement occurring after such date.

Conference Agreement

The conference agreement follows the Senate amendment except for the effective date.

Effective date.–The conference agreement applies to fees and costs paid after the date of enactment with respect to any judgment or settlement occurring after such date.

3. Exclusion from gross income for amounts paid under National Health Service Corps loan repayment program (sec. 644 of the Senate amendment and sec. 108 of the Code)

Present Law

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides education loan repayments to participants on condition that the participants provide certain services. In the case of the NHSC Loan Repayment Program, the recipient of the loan repayment is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health-care professionals. Loan repayments may be as much as $35,000 per year of service plus a tax assistance payment of 39 percent of the repayment amount.

States may also provide for education loan repayment programs for persons who agree to provide primary health services in health professional shortage areas. Under the Public Health Service Act, such programs may receive Federal grants with respect to such repayment programs if certain requirements are satisfied.

Generally, gross income means all income from whatever source derived including income for the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Because the loan repayments provided under the NHSC Loan Repayment Program or similar State programs under the Public Health Service Act are not specifically excluded from gross income, they are gross income to the recipient. There is also no exception from employment taxes (FICA and FUTA) for such loan repayments.

House Bill

No provision.

Senate Amendment

The provision excludes from gross income and employment taxes education loan repayments provided under the NHSC Loan Repayment Program and State programs eligible for funds under the Public Health Service Act. The provision also provides that such repayments are not taken into account as wages in determining benefits under the Social Security Act.

Effective date.–The provision is effective with respect to amounts received in taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Certain expenses of rural letter carriers (sec. 645 of the Senate amendment and sec. 162(o) of the Code)

Present Law

The deductible automobile expenses of rural letter carriers equal the reimbursements that such carriers receive from the U.S. Postal Service. Carriers are not allowed to document their actual costs and claim itemized deductions for costs in excess of reimbursements,[363] nor are carriers required to include in income reimbursements in excess of their actual costs.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, if the reimbursements a rural letter carrier receives from the U.S. Postal Service fall short of the carrier's actual costs, the costs in excess of reimbursements qualify as a miscellaneous itemized deduction subject to the two-percent floor. Reimbursements in excess of their actual costs continue not to be required to be included in gross income.

Effective date.–The provisions is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement follows the Senate amendment.

[363] Section 162(o).

5. Method of accounting for naval shipbuilders (sec. 646 of the Senate amendment)

Present Law

Generally, taxpayers must use the percentage-of-completion method to determine taxable income from long-term contracts.[364] Under sec. 10203(b)(2)(B) of the Revenue Act of 1987,[365] an exception exists for certain ship construction contracts, which may be accounted for using the 40/60 percentage-of-completion/ capitalized cost method ("PCCM"). Under the 40/60 PCCM, 60 percent of a taxpayer's long-term contract income is exempt from the requirement to use the percentage-of-completion method while 40 percent remains subject to the requirement. The exempt 60 percent of long-term contract income must be reported by consistently using the taxpayer's exempt contract method. Permissible exempt contract methods include the percentage of completion method, the exempt-contract percentage-of-completion method, and the completed contract method.[366]

House Bill

No provision.

Senate Amendment

The Senate amendment provides that qualified naval ship contracts may be accounted for using the 40/60 PCCM during the first five taxable years of the contract. The cumulative reduction in tax resulting from the provision over the five-year period is recaptured and included in the taxpayer's tax liability in the sixth year. Qualified naval ship contracts are defined as any contract or portion thereof that is for the construction in the United States of one ship or submarine for the Federal Government if the taxpayer reasonably expects the acceptance date will occur no later than nine years after the construction commencement date.

Effective date.–The Senate amendment is effective for contracts with respect to which the construction commencement date occurs after date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with the following modification. The provision specifies that the construction commencement date is the date on which the physical fabrication of any section or component of the ship or submarine begins in the taxpayer's shipyard.

[364] Sec. 460(a).

[365] Pub. Law No. 100-203 (1987).

[366] Treas. Reg. 1.460-4(c)(1).

Effective date.–The provision is effective for contracts with respect to which the construction commencement date occurs after date of enactment.

6. Distributions to shareholders from policyholders surplus account of life insurance companies (sec. 647 of the Senate amendment and sec. 815 of the Code)

Prior and Present Law

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account (sec. 815).

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

House Bill

No provision.

Senate Amendment

The Senate amendment provision suspends for a stock life insurance company's taxable years beginning after December 31, 2003, and before January 1, 2006, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company (sec. 815). The provision also reverses the order in which distributions reduce the various accounts, so that distributions would be treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement follows the Senate amendment, with a modification.

The conference agreement provision suspends for a stock life insurance company's taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company (sec. 815). The conference agreement includes the Senate amendment provision reversing the order in which distributions reduce the various accounts, so that distributions would be treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2004.

7. Motor vehicle dealer transitional assistance (sec. 650 of the Senate amendment)

Present Law

Under present law, no gain or loss is recognized on the exchange of property used in a trade or business or held for investment if the property is exchanged solely for property of like kind.[367] To qualify for nonrecognition treatment, the replacement property must be identified within 45 days and the exchange must be completed within 180 days after the transfer of the exchanged property. The basis of the replacement property is determined by reference to the basis of the exchanged property.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an election (on either an original or amended return) to defer the gain on termination payments received by a taxpayer from a motor vehicle manufacturer on account of the termination of a motor vehicle sales and service agreement, provided the proceeds are reinvested within two years in property used in a domestic motor vehicle dealership. Under the provision, a dealership in which the proceeds are reinvested within two years is treated as like kind replacement property under sec. 1031, without regard to the time limitations on identification of and acquisition of such replacement property under present law. The provision extends the statute of limitations for assessment of any deficiency attributable to gain on termination payments until three years after the taxpayer notifies the Secretary of the like-kind replacement property or an intention not to replace.

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[367] Sec. 1031(a)(1).

The Senate amendment applies only with respect to termination payments from a motor vehicle manufacturer who announced in December 2000 that it would phase out the motor vehicle brand to which the agreement relates.

Effective date.–The Senate amendment is effective for amounts received after December 12, 2000, in taxable years ending after that date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Expansion of designated renewal community area based on 2000 census data (sec. 651 of the Senate amendment and sec. 1400E of the Code)

Present Law

Section 1400E provides for the designation of certain communities as renewal communities.[368] An area designated as a renewal community is eligible for the following tax incentives: (1) a zero-percent rate for capital gain from the sale of qualifying assets; (2) a 15-percent wage credit to employers for the first $10,000 of qualified wages; (3) a "commercial revitalization deduction" that allows taxpayers (to the extent allocated by the appropriate State agency) to deduct either (a) 50 percent of qualifying expenditures for the taxable year in which a qualified building is placed in service, or (b) all of the qualifying expenditures ratably over a 10-year period beginning with the month in which such building is placed in service; (4) an additional $35,000 of section 179 expensing for qualified property; and (5) an expansion of the work opportunity tax credit with respect to individuals who live in a renewal community.

To be designated as a renewal community, a nominated area was required to meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress. There are no geographic size limitations placed on renewal communities. Instead, the boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

The designations of renewal communities were required to be made by December 31, 2001, using 1990 census data to determine relevant populations and poverty rates.

[368] Section 1400E was added by section 101(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

House Bill

No provision.

Senate Amendment

The Senate amendment permits the Secretary of Housing and Urban Development to expand a renewal community to include: (1) any census tract that at the time such community was nominated, satisfied the requirements for inclusion in such community but for the failure of such tract to satisfy one or more of the population and poverty rate requirements using 1990 census data, and that satisfies all failed population and poverty rate requirements using 2000 census data; or (2) an area that is adjacent to at least one other area designated as a renewal community and that has a population less than the generally applicable population requirement, if the area is one of pervasive poverty, unemployment, and general distress that is within the jurisdiction of one or more local governments and the boundary of the area is continuous, or the area contains a population of less than 100 people.

Effective date.–The provision is effective as if included in the amendments made by section 101 of the Community Renewal Tax Relief Act of 2000.

Conference Agreement

The conference agreement modifies the Senate amendment to authorize the Secretary of Housing and Urban Development, at the request of all of the governments that nominated a renewal community, to add a contiguous census tract to a renewal community in the following circumstances. First, the renewal community, including any tract to be added, would have met the renewal community eligibility requirements at the time of the community's original nomination, and any tract to be added has a poverty rate using 2000 census data that exceeds the poverty rate of such tract using 1990 census data. Second, a tract may be added to a renewal community even if the addition of such tract to such community would have caused the community to fail one or more eligibility requirements when originally nominated using 1990 census data, provided that: (1) the renewal community after the inclusion of such tract does not have a population that exceeds 200,000 using either 1990 or 2000 census data; (2) such tract has a poverty rate of at least 20 percent using 2000 census data; and (3) such tract has a poverty rate using 2000 census data that exceeds the poverty rate of such tract using 1990 census data. Census tracts that did not have a poverty rate determined by the Bureau of the Census using 1990 data may be added to an existing renewal community without satisfying requirement (3) above. Third, a tract may be added to an existing renewal community if such tract: (1) has no population using 2000 census data or no poverty rate for such tract is determined by the Bureau of the Census using 2000 census data; (2) such tract is one of general distress; and (3) the renewal community, including such tract, is within the jurisdiction of one or more local governments and has a continuous boundary.

Effective date.–The conference agreement provision is effective as if included in the amendments made by section 101 of the Community Renewal Tax Relief Act of 2000.

9. Reduction of holding period to 12 months for purposes of determining whether horses are section 1231 assets (sec. 652 of the Senate amendment and sec. 1231 of the Code)

Present Law

Under present law, gain from the sale or exchange of horses held for draft, breeding, or sporting purposes qualify for long-term capital gain if the horse has been held for 24 months or more.

House Bill

No provision.

Senate Amendment

The Senate amendment reduces the holding period for horses to 12 months or more.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the provision in the Senate amendment.

10. Blue ribbon commission on comprehensive tax reform (sec. 653 of the Senate amendment)

Present Law

Under present law, there is no specially-appointed commission designated to study and report on comprehensive tax reform.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a commission to study and report on comprehensive tax reform. Members of the commission are to be appointed by Congressional leadership and the President.

Effective date.–Members must be appointed by October 30, 2004. The report is due no later than 18 months after all members are appointed.

Conference Agreement

The conference agreement does not include the Senate amendment.

11. Temporary accumulated earnings tax safe harbor (sec. 655 of the Senate amendment and sec. 537 of the Code)

Present Law

Present law imposes an accumulated earnings tax on the accumulated taxable income of a corporation that is formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed.[369]

The accumulated earnings tax is in addition to the regular corporate level tax and is imposed at the maximum rate that would be imposed on a dividend to an individual shareholder. A corporation is generally permitted to accumulate an exempted amount of $250,000 ($150,000 in the case of certain service corporations); the tax is then imposed on accumulated taxable income above that amount.

The fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary. If a corporation is a "mere holding or investment company," that fact is prima facie evidence of the prohibited purpose.[370] Treasury regulations provide that even in cases of accumulation of earnings beyond the reasonable needs of the business or where a corporation is a mere holding or investment company, such facts are not absolutely conclusive against the taxpayer if the taxpayer satisfies the Commissioner that the corporation was neither formed not availed of for the purpose of avoiding income tax with respect to shareholders.[371]

The determination whether earnings and profits have been accumulated beyond the reasonable needs of the business is based on facts and circumstances. The reasonable needs of the business include "reasonably anticipated" needs of the business.[372] Some courts have applied a business cycle approach in determining the basic working capital needs of a business, to which

[369] Under present law, corporate income is taxed at graduated rates ranging from 15 percent to 35 percent. A corporation is also entitled to a dividends-received deduction of at least 70 percent for dividends received from other corporations. Thus, the maximum corporate rate on dividends received from other corporations is 10.5 percent. Individual income is generally taxed at graduated rates up to 35 percent. However, dividends are taxed at a maximum rate of 15 percent. The maximum individual rates are scheduled to return to 39.6 percent on dividends as well as on other ordinary income after the year 2009.

[370] Sec. 533.

[371] Treas. Reg. sec. 1.533-1(a).

[372] Treas. Reg. secs. 1. 537-1, 1.537-2 and 1.537-3.

additional reasonably anticipated future needs may be added. Disputes have arisen regarding the choice of business cycle and the proper addition of future needs.[373]

House Bill

No provision.

Senate Amendment

The bill provides that the reasonably anticipated needs of a business for any taxable year shall include working capital for the business in an amount which is not less than the sum of the cost of goods, operating expenses, and interest expense which the business incurred during the preceding taxable year. Any amounts incurred as part of a plan a principal purpose of which is to increase the limitation under this provision is not taken into account.

Effective date.–The provision applies to taxable years beginning after December 31, 2003 and before January 1, 2009.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Tax Treatment of State Ownership of Railroad REIT (sec. 656 of the Senate amendment and secs. 103, 115, 336 and 337 of the Code)

Present Law

A real estate investment trust ("REIT") is an electing entity that is engaged primarily in passive real estate activities (as specifically defined) and that, among other requirements, must have at least 100 shareholders. If a qualified entity elects REIT status, it can be taxed essentially as a pass-through entity, since it can obtain a deduction for amounts distributed to its shareholders and it is required to distribute at least 90 percent of its income to shareholders annually.

If an entity does not qualify to be treated as a REIT, it would generally be treated as a regular C corporation subject to tax under subchapter C of the Code and section 11 at the corporate entity level, unless it elected to be taxed as a partnership or disregarded entity under Treasury regulations. Even if it made such an election, the C corporation would be treated as if it had liquidated and distributed its assets to shareholders, with a resulting corporate tax on the excess of fair market value over basis of any corporate assets. A C corporation that becomes a tax-exempt entity also must pay corporate tax on the excess of the fair market value over the basis of its assets.

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[373] *See, e.g., Bardahl Manufacturing Corp.*, 24 TCM 1030 (1965); *Bardahl International Corp.*, 25 TCM 935 (1966); *Empire Steel Castings, Inc.*, 33 TCM 155 (1974); *Alma- Piston Co. v. Commissioner*, 579 F.2d 1000 (6th Cir. 1978); *C.E. Hooper, Inc*. 76-1 USTC par. 9185(Ct. Cl. 1976).

A State or local government is not subject to Federal income tax on income from an activity that is an essential governmental function.[374]

Interest on a State or local bond is excluded from gross income, with certain exceptions.[375] Special rules are also provided as requirements for tax exemption for State and local bonds. [376]

House Bill

No provision.

Senate Amendment

The bill provides that a qualified railroad corporation that is a REIT that meets certain qualified activity requirements (described further below) and that becomes 100 percent owned by a State after December 31, 2003 and before December 31, 2005, will not be treated as a taxable C corporation, but will be taxed as if its income from the qualified activities accrued directly to the State. To the extent its described railroad activities qualify under present law as essential governmental functions, income from such activities shall be tax exempt under section 115 of the Code.

Under the bill, no gain or loss shall be recognized from the deemed conversion of such a REIT to a C corporation which is tax-exempt, and no change in the basis of the property of the entity shall occur.

Also, any obligation issued by an entity described above is treated as an obligation of a State for purposes of applying the tax exempt bond provisions.

A qualified railroad corporation that is a REIT must be a non-operating Class III railroad, and substantially all of its activities must consist of the ownership, leasing, and operation by such corporation of facilities, equipment, and other property used by the corporation or other persons in railroad transportation.

Effective date.–The bill applies on and after the date a State becomes the owner of all the outstanding stock of a qualified corporation, provided that the State becomes the owner of all the voting stock of the corporation on or before December 31, 2003 and becomes the owner of all the outstanding stock of the corporation on or before December 31, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[374] Sec. 115.

[375] Sec. 103.

[376] Secs. 141-150.

13. Contribution in aid of construction (sec. 657 of the Senate amendment and sec. 118 of the Code)

Present Law

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

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that water and sewer service laterals (amounts paid to connect the customer's water service line or sewer lateral line to the utility's distribution or collection system, or to extend a main water or sewer line to provide service to a customer) received by a regulated public utility that provides water or sewerage disposal services is considered a contribution to capital and excludible from gross income of such utility.

Effective date.–The Senate amendment provision is effective for contributions made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Credit for purchase and installation of agricultural water conservation systems (sec. 658 of the Senate amendment)

Present Law

There is no provision that provides for a credit for agricultural water systems.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 30-percent credit (not to exceed $500 per acre) for water conservation system expenses for taxpayers who normally derive at least 50 percent of their gross income from land. The term 'water conservation system expenses' means expenses for the purchase and installation of a water conservation system but only if (1) the land served by the water conservation system is entirely in a county or county-equivalent area which has received, in the taxable year the expenses were paid or incurred or in any of the three preceding taxable years, a primary-county designation due to drought by the Secretary of Agriculture, and (2) such system is certified as saving at least 5 percent more irrigation water than the irrigation system which was used on such land immediately prior to the installation of such water conservation system.

The term 'water conservation system' means (1) new or replacement irrigation equipment and machinery, including sprinklers, pipes, siphons, nozzles, pumps, motors, and engines, and (2) computer systems for irrigation and water management.

The irrigation water savings shall be determined and certified under regulations prescribed jointly by the Natural Resources Conservation Service of the Department of Agriculture and the Bureau of Reclamation of the Department of the Interior. Such regulations shall include a list of individuals or organizations qualified to make such certification.

No deduction is allowed with respect to any expenses taken into account in determining the credit, and any increase in the basis of any property which would result from such expense shall be reduced by the amount of credit allowed for such expense.

Effective date.–The credit is available for expenses occurred after date of enactment with respect to systems completed after December 31, 2004 and prior to January 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment.

15. Modification of involuntary conversion rules for businesses affected by the September 11th terrorist attacks (sec. 659 of the Senate amendment and sec. 1400L of the Code)

Present Law

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

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

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

House Bill

No provision.

Senate Amendment

The Senate amendment provides special rules for property which is compulsorily or involuntarily converted as a result of the terrorist attacks on September 11, 2001, in the New York Liberty Zone. The special rules provide that a corporation which is a member of an affiliated group filing a consolidated tax return shall be treated as satisfying the repurchase requirement of section 1033 with respect to such property to the extent the requirement is satisfied by another member of the corporation's affiliated group. In addition, the provision extends the replacement period for such property to five years after the close of the first taxable year in which gain is realized, if substantially all the use of the replacement property is in New York City.

Effective date.–The Senate amendment is effective for involuntary conversions occurring on or after September 11, 2001.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

16. Repeal of application of below-market loan rules to amounts paid to certain continuing care facilities (sec. 660 of the Senate amendment and sec. 7872 of the Code)

Present Law

Certain loans that bear interest at a below-market interest rate are treated as loans bearing interest at the market rate accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction (*e.g.*, gift, compensation, dividend, etc.).[377] The market rate of interest for purposes of the

[377] Sec. 7872.

below-market loan rules is assumed to be 100 percent of the applicable Federal rate ("AFR") at the time the loan is made in the case of a term loan or, in the case of a demand loan, 100 percent of the AFR in effect over the time that the loan is outstanding.

In general, the below-market loan rules apply to (1) loans where the foregone (i.e., below-market) interest is in the nature of a gift, (2) loans between an employee and an employer or between an independent contractor and one for whom the independent contractor provides services, (3) loans between a corporation and a shareholder of the corporation, (4) loans of which one of the principal purposes of the interest arrangement is the avoidance of Federal tax, (5) to the extent provided in Treasury regulations, any other below-market loans if the interest arrangement of such loan has a significant effect on any Federal tax liability of either the lender or borrower, and (6) loans to any qualified continuing care facility pursuant to a continuing care contract.

In the case of loans made to qualified continuing care facilities,[378] an exception from the below-market loan rules is provided for any loan as of the calendar year in which the lender has attained age 65, provided the loan is made by the lender to the qualified continuing care facility pursuant to a continuing care contract.[379] However, the exception applies only to the extent that the principal amount of the loan, when added to the aggregate outstanding amount of all other previous loans between the lender (or the lender's spouse) and any qualified continuing care facility, does not exceed $90,000. This amount is indexed for inflation, and the amount for calendar year 2004 is $154,500.[380]

With regard to continuing care facilities that are not qualified continuing care facilities, the IRS takes the position that loans made to such facilities by residents are not subject to the

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[378] A "qualified continuing care facility" is defined as one or more facilities (1) which are designed to provide services under continuing care contracts, and (2) substantially all of the residents of which are covered by continuing care contracts. However, a facility is not a qualified continuing care facility unless substantially all facilities which are used to provide services that are required to be provided under a continuing care contract are owned or operated by the borrower. In addition, nursing homes do not constitute continuing care facilities (sec. 7872(g)(4)).

[379] A "continuing care contract" is defined as a written contract between an individual and a qualified continuing care facility under which (1) the individual or individual's spouse may use a qualified continuing care facility for their life or lives, (2) the individual or individual's spouse (a) will first reside in a separate, independent living unit with additional facilities outside such unit for the providing of meals and other personal care, and (b) then will be provided long-term and skilled nursing care as the health of such individual or individual's spouse requires, and (3) no additional substantial payment is required if such individual or individual's spouse requires increased personal care services or long-term and skilled nursing care.

[380] Rev. Rul. 2003-118, 2003-47 I.R.B. 1095.

below-market loan rules until and unless Treasury regulations are issued that treat such loans as having a significant effect on any Federal tax liability of either the facility or the resident.[381]

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the application of the below-market loan rules to loans that are made to any qualified continuing care facility pursuant to a continuing care contract, without regard to the principal amount of the loan (including the aggregate outstanding amount of any other previous loans between the resident or resident's spouse and any qualified continuing care facility). The Senate amendment also clarifies that the determination of whether a facility is a qualified continuing care facility is to be made on an annual basis at the end of each calendar year, rather than only when the continuing care contract is entered into. In addition, the Senate amendment modifies the definition of a continuing care contract to (1) not exclude contracts that require additional substantial payment for increased personal care services required by the resident or resident's spouse, and (2) provide authority for the Treasury to issue guidance that limits such definition to contracts that provide to the resident or resident's spouse only facilities, care and services that are customarily offered by continuing care facilities. The Senate amendment also clarifies that the definition of a qualified continuing care facility requires substantially all of the independent living unit residents of the facility to be covered by continuing care contracts.

The Senate amendment does not affect the present-law application of the below-market loan rules to loans made to any continuing care facility that is not a qualified continuing care facility.

Effective date.–The Senate amendment provision applies to calendar years beginning after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment.

[381] Tech. Adv. Mem. 9521001 (Dec. 7, 1994).

17. Maximum capital gain rates of individuals for gold, silver, platinum, and palladium (sec. 661 of the Senate amendment and sec. 1(h) of the Code)

Present Law

Under present law, the net capital gain of an individual is generally taxed at a maximum rate of 15 percent (five percent for gain otherwise taxed at the 10- or 15-percent rate). However, the maximum tax rate for individuals from the sale or exchange of a collectible is 28 percent. Gold, silver, platinum or palladium bullion is defined as a collectible for this purpose.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, gold, silver, platinum and palladium bullion is not treated as a "collectible" for purposes of applying the individual capital gain rates. Thus, gain or loss from the sale of the bullion will qualify for the lower five- and 15-percent capital gain rates.

Effective date.–Taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the provision in the Senate amendment.

18. Inclusion of primary and secondary medical strategies for children and adults with sickle cell disease as medical assistance under the medicaid program (sec. 662 of the Senate amendment)

Present Law

Medicaid programs are generally operated by the States, in part with funds received from the Federal government. Within broad Federal guidelines, States can design the scope and availability of Medicaid benefits. Medicaid law requires States to provide certain services including, for example, hospital and physician services. Federal funds are available for additional optional services if States choose to include them in their Medicaid plans. Within Federal guidelines, States may limit the amount, duration of any Medicaid service. Under present law, States may have covered some of the primary and secondary medical strategies, treatments, and services for Sickle Cell Disease, however such services are not specifically listed in the Medicaid statute as either mandatory or optional services.

The Federal government shares in States' Medicaid service costs by means of a statutory formula designed to provide a higher Federal matching rate to States with lower per capita incomes. The Federal share is referred to as the Federal Medical Assistance Percentage ("FMAP"). For some Medicaid services and activities, such as costs associated with program administration, the FMAP rate is set in statute. Because Medicaid is an individual entitlement, there is no annual ceiling on Federal expenditures; however, in order to continue receiving Federal payments, States must contribute their share of the matching funds.

House Bill

No provision.

Senate Amendment

The Senate amendment amends Title XIX of the Social Security Act to add primary and secondary medical strategies, treatment and services for individuals who have Sickle Cell Disease as a new optional medical assistance category under the Medicaid program. Such strategies, treatment, and services include: (1) chronic blood transfusion (with deferoxamine chelation) to prevent stroke in individuals with Sickle Cell Disease who have been identified as being at high risk for stroke; (2) genetic counseling, testing, and treatment for individuals with Sickle Cell Disease or the Sickle Cell trait; and (3) other treatment and services to prevent individuals who have Sickle Cell Disease and who have had a stroke having another stroke. The amendment sets the FMAP rate at 50 percent for costs attributable to providing: (1) services to identify and educate likely Medicaid enrollees who have or are carriers of Sickle Cell Disease; or (2) education regarding the risks of stroke and other complications, as well as the prevention of stroke and complications for likely Medicaid enrollees with Sickle Cell Disease.

The Senate amendment also authorizes an appropriation in the amount of $10,000,000 for each of fiscal years 2005 through 2009 for a demonstration program under which the Administrator of the Health Resources and Services Administration (through the Bureau of Primary Health Care and the Maternal Child Health Bureau) would make grants up to 40 eligible entities in each such fiscal year for the development and establishment of systemic mechanisms for the prevention and treatment of the Sickle Cell Disease. Eligible entities include Federally-qualified health centers as defined in the Medicaid statute; nonprofit hospitals or clinics, or university health centers that provide primary health care that: (1) have a collaborative agreement with a community-based Sickle Cell Disease organization or a nonprofit entity with experience in working with individuals who have the Sickle Cell Disease; and (2) demonstrate that they have at least five years of experience in working with individuals who have the Sickle Cell Disease. Systematic mechanisms for the prevention and treatment of the Sickle Cell Disease include: (1) coordination of service delivery for individuals with the disease; (2) genetic counseling and testing; (3) bundling of technical services related to the prevention and treatment of the disease; (4) training health professionals; and (5) identifying and establishing efforts related to the expansion and coordination of education, treatment, and continuity of care programs for individuals with the disease.

In awarding such grants to eligible entities, the Administrator of Health Resources and Services Administration is to take into consideration geographic diversity and to give priority to: (1) Federally-qualified health centers that have a partnership or other arrangement with a comprehensive Sickle Cell Disease treatment center and does not receive funds from the National Institutes of Health; or (2) Federally-qualified health centers that intend to develop a partnership or other arrangement with a comprehensive Sickle Cell Disease treatment center, and that does not receive funds from the National Institutes of Health. Eligible entities that are awarded grants are required to use the funds for the following activities: (1) to facilitate and coordinate the delivery of education, treatment, and continuity of care under: (a) the entity's collaborative agreement with a community-based Sickle Cell Disease organization or a nonprofit entity that works with individuals who have Sickle Cell Disease; (b) the Sickle Cell Disease newborn screening program for the State in which the entity is located; and (c) the Maternal and Child Health program for the State in which the entity is located; (2) to train nursing and other health staff who provide care for individuals with Sickle Cell Disease; (3) to enter into a partnership with adult or pediatric hematologists in the region and other regional experts in the Sickle Cell Disease at tertiary or academic health centers and State and county health offices; and (4) to identify and secure resources for ensuring reimbursement under the Medicaid program, State children's health insurance program, and other health programs for the prevention and treatment of Sickle Cell Disease.

The Senate amendment also requires the Administrator of Health Resources and Services Administration to enter into a contract with an entity and to serve as a National Coordinating Center for the demonstration program. The center is to: (1) collect, coordinate, monitor and distribute data, best practices, and findings regarding the activities funded under grants made to eligible entities under the demonstration program; (2) develop a model protocol for eligible entities with respect to prevention and treatment of the disease; (3) develop educational materials regarding the prevention and treatment of the disease; and (4) submit a written report to Congress. The written report to Congress should include recommendations on the effectiveness of the demonstration program direct outcome measures, such as the number and type of health care resources utilized (such as emergency room visits, hospital visits, length of stay, and physician visits for individuals with Sickle Cell Disease) and the number of individuals that were tested and subsequently received genetic counseling for the sickle cell trait.

Effective date.–The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment provision.

19. Mortgage payment assistance (secs. 901 and 902 of the Senate amendment)

Present Law

There is no provision in present law that authorizes the Secretary of Housing and Urban Development to award low-interest loans to individuals adversely affected by international economic activity to enable such individuals to make mortgage payments with respect to their primary residences.

House Bill

No provision.

Senate Amendment

The Senate amendment requires the Secretary of Housing and Urban Development (the "Secretary") to establish a program for awarding low-interest loans to eligible individuals to enable such individuals to continue making mortgage payments with respect to their primary residences. The provision provides that the Secretary shall issue regulations no later than six weeks after the date of enactment to implement this program.

An individual eligible to receive a loan under the program must be: (1) a worker that is adversely affected by international economic activity, as determined by the Secretary; (2) a borrower on a loan that requires monthly mortgage payments with respect to the primary residence of the individual; and (3) enrolled in a training or assistance program. The amount of a loan provided under the program cannot exceed the aggregate amount of monthly mortgage payments the borrower would owe during a 12-month period. In addition, a loan provided under the program must have an applicable interest rate of four percent and must provide for monthly repayments over a five-year period.

The provision authorizes appropriations of $10 million for each of the years 2005 through 2009 to carry out the purposes of the provision.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

20. Protection of overtime pay (secs. 489-490 of the Senate amendment and sec. 13 of the Fair Labor Standards Act of 1938)

Present Law

The Fair Labor Standards Act of 1938 ("FLSA") establishes minimum wage and overtime pay requirements that apply to employees, subject to certain exemptions.[382] On April 23, 2004, the Department of Labor issued revised regulations implementing exemptions from the FLSA minimum wage and overtime pay requirements.[383] Among other changes, the regulations increased the salary threshold for employees to be exempt from these requirements.

House Bill

No provision.

[382] *See,* sections 6, 7, and 13 of the FLSA, 29 U.S.C. sections 206, 207, and 213 (2004).

[383] 69 Fed. Reg. 22,122 (April 23, 2004).

Senate Amendment

The Senate amendment contains provisions relating to the authority of the Secretary of Labor to issue regulations implementing the overtime pay requirement and the effect of recently issued regulations.

Under the Senate amendment, the Secretary of Labor may not issue any regulation that exempts from the overtime pay requirement any employee who earns less than $23,660 per year. In addition, the Secretary of Labor may not issue any regulation concerning the right to overtime pay that is not as protective, or more protective, of the overtime pay rights of employees in certain specified occupations or job classifications (as listed in the provision) as the protections provided for such employees under the regulations in effect on March 31, 2003. Any portion of a regulation issued after March 31, 2003, that modifies the overtime pay requirement in a manner that is inconsistent with the provisions of the Senate amendment will have no force or effect as it relates to the occupation or job classification involved.

The Senate amendment also provides that, notwithstanding the Administrative Procedures Act or any other provision of law, any portion of the Labor regulations issued on April 23, 2004, that exempts from the overtime pay requirement any employee who would not otherwise be exempt if the regulations in effect on March 31, 2003, remained in effect, will have no force or effect. In addition, the portion of the regulations (as in effect on March 31, 2003) that would prevent any employee from being exempt shall remain in effect. Nonetheless, the increased salary requirements provided for in the regulations issued on April 23, 2004, will remain in effect.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provisions.

21. Report on acquisitions of goods from foreign sources (sec. 1001 of the Senate amendment and sec. 43 of the Office of Federal Procurement Policy Act)

Present Law

Public Law 93-400, "The Office of Federal Procurement Policy Act", as amended, created the Office of Federal Procurement Policy (“OFPP”) in 1974 and placed it in the Office of Management and Budget (“OMB”). The OFPP was created, among other purposes, to provide Government-wide procurement policies which are to be followed by Executive agencies in procurement activities.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that, not later than 60 days after the end of each fiscal year, each executive agency is to submit to the Congress a report on the acquisitions that were made of articles, materials, or supplies by the agency in that fiscal year from sources outside the United States. The report is to separately include the following information: (1) the dollar value of any articles, materials, or supplies that were manufactured outside the United States; (2) an itemized list of all waivers granted with respect to such articles, materials, or supplies under the Buy American Act; and (2) a summary of the (a) the total procurement funds expended on articles, materials and supplies manufactured outside the United States and (b) the total procurement funds expended on articles, materials, and supplies manufactured outside the Untied States. The agency is to make the report publicly available by posting the report on the Internet.

The reporting requirement does not apply to any procurement for national security purposes entered into by: (1) the Department of Defense or any agency or entity thereof; (2) the Departments of the Army, Navy, and Air Force or any agency or entity of any of the military departments; (3) the Department of Homeland Security; (4) the Department of Energy or any agency or entity thereof, with respect to the national security programs of the Department of Energy; or (5) any element of the intelligence community.

The Senate amendment also provides that, not later than 60 days after the end of each fiscal year ending after the date of enactment, the Secretary of Commerce is to submit to Congress a report on the acquisitions by foreign governments of articles, materials, or supplies that were manufactured or extracted in the United States in that fiscal year. The report is to indicate the dollar value of such articles, materials, or supplies and is to be made publicly available by posting on the Internet.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

22. Minimum cost requirement for excess asset transfers (sec. 719 of the Senate amendment and sec. 420 of the Code)

Present Law

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[384] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan's assets[385] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[386] In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for a transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order for a transfer to be qualified, the transfer must meet the minimum cost requirement. To satisfy the minimum cost requirement, an employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four

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[384] Sec. 420.

[385] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[386] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

years (referred to as the cost maintance period). The applicable employer cost during the cost maintenance period cannot be less than the higher of the applicable employer costs for each of the two taxable years preceding the taxable year of the transfer. The applicable employer cost is generally determined by dividing the current retiree health liabilities by the number of individuals provided coverage for applicable health benefits during the year. The Secretary is directed to prescribe regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the period from being treated as satisfying the minimum cost requirement.

Under Treasury regulations,[387] the minimum cost requirement is not satisfied if the employer significantly reduces retiree health coverage during the cost maintenance period. Under the regulations, an employer significantly reduces retiree health coverage for a year (beginning after 2001) during the cost maintenance period if either (1) the employer-initiated reduction percentage for that taxable year exceeds 10 percent, or (2) the sum of the employer-initiated reduction percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.[388] The employer-initiated reduction percentage is percentage of the number of individuals receiving coverage for applicable health benefits as of the day before the first day of the taxable year over the total number of such individuals whose coverage for applicable health benefits ended during the taxable year by reason of employer action.[389]

House Bill

No provision.

Senate Amendment

The Senate amendment provides that an eligible employer does not fail the minimum cost requirement if, in lieu of any reduction of health coverage permitted by Treasury regulations, the employer reduces applicable employer cost by an amount not in excess of the reduction in costs which would have occurred if the employer had made the maximum permissible reduction in retiree health coverage under such regulations. An employer is an eligible employer if, for the preceding taxable year, the qualified current retiree health liabilities of the employer were at least five percent of gross receipts.

In applying such regulations to any subsequent taxable year, any reduction in applicable employer cost under the proposal is treated as if it were an equivalent reduction in retiree health coverage.

Effective date.–The provision is effective for taxable years ending after the date of enactment.

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[387] Treas. Reg. sec. 1.420-1(a).

[388] Treas. Reg. sec. 1.420-1(b)(1).

[389] Treas. Reg. sec. 1.420-1(b)(2).

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE IX – ENERGY TAX INCENTIVES

A. Credit for Electricity Produced from Certain Sources (sec. 801 of the Senate amendment and sec. 45 of the Code)

Present Law

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

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2006, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2006, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2006. 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.

House Bill

No provision.

Senate Amendment

Extension of placed in service date for existing facilities

The Senate amendment 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.

Modification of credit amount

The Senate amendment modifies the credit rate applicable to electricity produced from after December 31, 2004 from facilities placed in service after December 31, 2004 to be 1.8 cents per kilowatt hour and repeals the indexing of the credit amount.

Additional qualifying facilities

The Senate amendment also defines six new qualifying energy resources: open-loop biomass including agricultural livestock waste nutrients, geothermal energy, solar energy, municipal biosolids and sludge, small irrigation, and municipal solid waste.

Open-loop 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 residues, other than spent chemicals from pulp manufacturing, 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 open-loop biomass does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. In addition, open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (cofiring) beyond such fossil fuel required for start up and flame stabilization.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure.

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 and sludge are the residue or solids removed by a municipal wastewater treatment facility. Sludge is the recycled residue byproduct created in the treatment of commercial, industrial, municipal, or navigational wastewater, but not including residues from incineration.

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.

Qualifying open-loop biomass facilities, other than qualifying agricultural livestock waste nutrient facilities are facilities using open-loop 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 December 31, 2004 and before January 1, 2007. Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after December 31, 2004 and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service December 31, 2004 and before January 1, 2007. Qualifying municipal biosolids and sludge facilities are facilities using municipal biosolids or sludge to generate electricity that are originally placed in service after December 31, 2004, and before January 1, 2007. Qualifying small irrigation power facilities are facilities using small irrigation power systems to generate electricity that are originally placed in service after December 31, 2004 and before January 1, 2007. Qualifying municipal solid waste facilities are facilities or units incinerating municipal solid waste placed in service after December 31, 2004 and before January 1, 2007.

In the case of qualifying open-loop biomass facilities placed in service prior to January 1, 2005, taxpayers may claim a credit of 1.2 cents per kilowatt hour, rather than 1.8 cents per kilowatt hour for the five-year period beginning on January 1, 2005. the otherwise allowable credit for a three-year period. For a facility placed in service after the date of enactment, the three-year period commences when the facility is placed in service.

In addition, the Senate amendment 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, with other biomass, or both, before January 1, 2007. The amount of credit the taxpayer may claim credit is adjusted for the thermal value of the qualifying closed-loop biomass relative to the thermal value of the closed-loop biomass and the coal. The ten-year credit period for such a qualifying facility commences no earlier than January 1, 2005.

Credit claimants and treatment of other subsidies

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, the Senate amendment permits a lessee operator to claim the credit in lieu of the owner of the facilities.

The Senate amendment 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 trades 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.

The Senate amendment 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.

Effective date.–The Senate amendment is generally is effective for electricity sold from qualifying facilities after December 31, 2004. 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, 2005.

Conference Agreement

The conference agreement follows the Senate amendment with modifications.

Extension of placed in service date for existing facilities

The conference agreement does not include the provisions of the Senate amendment with respect to the extension of placed in service dates for qualifying wind, closed-loop, and poultry waste facilities.

Modification of placed in service date for existing facilities

The conference agreement includes the Senate amendment provision with respect to qualifying closed-loop biomass facilities 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, with the modification that the 10-year credit period begin no earlier than the date of enactment of the provision.

Additional qualifying resource and facilities

The conference agreement also defines five new qualifying resources for the production of electricity: open-loop biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, and municipal solid waste. Two different qualifying facilities use municipal solid waste as a qualifying resource: landfill gas facilities and trash combustion facilities. In addition, the conference agreement defines refined coal as a qualifying resource.

Qualifying open-loop biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2006. 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, 2006. The installed capacity of a qualified agricultural livestock waste nutrient facility is not less than 150 kilowatts.

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, 2006. 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, 2006. A qualifying geothermal energy facility or solar energy facility may not have claimed any credit under sec. 48 of the Code.[390]

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2006. 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 not less than 150 kilowatts and less than five megawatts.

Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying landfill gas facilities and qualifying trash combustion facilities include facilities used to produce electricity placed in service after the date of enactment and before January 1, 2006.

[390] If a geothermal facility or solar facility claims credit for any year under section 45 of the Code, the facility is precluded from claiming any investment credit under section 48 of the Code in the future.

Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less SO_2 and nitrogen oxides than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam. A qualifying refined coal facility is a facility producing refined coal that is placed in service after the date of enactment and before January 1, 2009.

Credit period and credit rates

In general, as under present law, taxpayers may claim the credit at a rate of 1.5 cents per kilowatt-hour (indexed for inflation and currently 1.8 cents per kilowatt-hour) for 10 years of production commencing on the date the facility is placed in service. In the case of open-loop biomass facilities, (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, landfill gas facilities, and trash combustion facilities the 10-year credit period is reduced to five years commencing on the date the facility is placed in service. In general, for facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period shall begin no earlier than the date of enactment.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrients), small irrigation power, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is reduced by one half.

An alternative credit applies for the production of refined coal. A qualified refined coal facility may claim credit at a rate of $4.375 per ton (indexed for inflation after 1992) of refined coal sold to a unrelated person. As is the case for facilities that produce electricity, the credit a taxpayer may claim for the production of refined coal is phased out as the market price of refined coal exceeds certain threshold levels. The threshold is defined by reference to the price of feedstock fuel used to produce refined coal. Thus if a producer of refined coal uses Powder River Basin coal as a feedstock, the threshold price is determined by reference to prices of Powder River Basin coal. If the producer uses Appalachian coal, the threshold price is determined by reference to prices of Appalachian coal.

Credit claimants and treatment of other subsidies

A lessee or operator may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities originally placed in service on or before the date of enactment and in the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass.

In addition, for all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, any reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits cannot exceed 50 percent. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The amendments made by the conference report do not apply with respect to any poultry waste facility placed in service prior to January 1, 2005. Such facilities placed in service after December 31, 2004 generally may qualify for credit as animal livestock waste nutrient facilities.

No facility that previously claimed or currently claims credit under section 29 of the Code is a qualifying facility for purposes of section 45.

Effective date.–The provision is effective for electricity produced and sold from qualifying facilities after the date of enactment in taxable years ending after the date of enactment. With respect to open-loop biomass facilities placed in service prior to January 1, 2005, the provisions are effective for electricity produced and sold after December 31, 2004.

B. Alternative Motor Vehicles and Fuels Incentives

1. Alternative motor vehicle credit (sec. 811 of Senate amendment)

Present Law

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).[391] 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 allowed is 25 percent of the otherwise allowable amount in 2006, and is unavailable for purchases after December 31, 2006.

House Bill

No provision.

Senate Amendment

Fuel cell motor vehicles

The Senate amendment provides a credit for the purchase of qualified fuel cell motor vehicles. The base credit for the purchase of new qualified fuel cell motor vehicles ranges between $4,000 and $40,000 depending upon the weight class of the vehicle. For automobiles and light trucks, the otherwise allowable credit amount ($4,000) is increased by an amount from $1,000 to $4,000 if the vehicle meets certain fuel economy increases compared to a stated standard. Credit may not be claimed for qualified fuel cell motor vehicles purchased after December 31, 2011.

Hybrid motor vehicles

The Senate amendment provides a credit for the purchase of qualified hybrid motor vehicles. The base credit for the purchase of a new qualified hybrid motor vehicle ranges from $250 to $10,000 depending upon the weight of the vehicle and the maximum power available from the vehicle's rechargeable energy storage system. For automobiles and light trucks, the otherwise allowable credit amount ($250 to $1,000) is increased by an amount from $500 to $3,000 if the vehicle meets certain fuel economy increases. For heavy duty hybrid motor vehicles, the otherwise allowable credit ($1,000 to $10,000) is increased depending upon the vehicle's weight and provided the vehicle meets certain 2007 (and beyond) emissions standards. The amount of credit is increased by between $2,500 and $10,000 for vehicles placed in service

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[391] A hybrid-electric vehicle may qualify as a clean-fuel vehicle under present law.

in 2004; is increased by between $2,500 and $10,000 for vehicles placed in service in 2004, is increased by between $2,000 and $8,000 for vehicles placed in service in 2005, and is increased by between $1,500 and $6,000 for vehicles placed in service in 2006. Credit may not be claimed for qualified hybrid motor vehicles purchased after December 31, 2006.

Alternative fuel motor vehicles

The Senate amendment provides a credit for the purchase of qualified alternative fuel motor vehicles. The base credit for the purchase of a new alternative fuel motor vehicle equals 40 percent of the incremental cost of such vehicle. The otherwise allowable credit for 40 percent of the incremental cost is increased by an additional 30 percent of the incremental cost of the vehicle if the vehicle meets certain emissions standards. For computation of the credit, the incremental cost of the vehicle may not exceed between $5,000 and $40,000 (resulting in a maximum total credit of between $3,500 and $28,000) depending upon the weight of the vehicle. For this purpose, incremental cost generally is defined as the amount of the increase of the manufacturer's suggested retail price of such a vehicle compared to the manufacturer's suggested retail price of a comparable gasoline or diesel model. 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). 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.

Taxpayers purchasing certain mixed-fuel vehicles also may claim the alternative fuel motor vehicle credit, at a reduced rate. A mixed-fuel vehicle is a vehicle with gross weight of seven tons or more and is certified by the manufacturer as being able to operate on a combination of alternative fuel and a petroleum-based fuel. A qualifying mixed-fuel vehicle must use at least 75 percent alternative fuel (a "75/25 mixed-fuel vehicle") or 90 percent alternative fuel (a "90/10 mixed-fuel vehicle") and be incapable of operating on a mixture containing less than 75 percent alternative fuel in the case of a 75/25 vehicle (less than 90 percent alternative fuel in the case of a 90/10 vehicle). A taxpayer purchasing a 75/25 mixed-fuel vehicle may claim 70 percent of the otherwise allowable credit. A taxpayer purchasing a 90/10 mixed-fuel vehicle may claim 90 percent of the otherwise allowable credit.

Credit may not be claimed for qualified alternative fuel motor vehicles purchased after December 31, 2006. The taxpayer's basis in the property is reduced by the amount of credit claimed.

Provisions of general application

The Senate amendment provides that unused credits may be carried forward for 20 years and three years (but not into taxable years beginning before January 1, 2005).

If a tax-exempt person purchases or leases a qualifying vehicle, the seller or lessor may claim the credit.

Effective date.–The Senate amendment is effective for property placed in service after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Modification of credit for electric vehicles (sec. 812 of Senate amendment and sec. 30 of the Code)

Present Law

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 2006. The credit allowed is 25 percent of the otherwise allowable amount for 2006, and is unavailable for purchases after December 31, 2006. There is no carry forward or carryback of the credit for electric vehicles.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the present-law credit for electric vehicles to provide that the credit for qualifying vehicles generally ranges between $3,500 and $40,000 depending upon the weight of the vehicle and, for certain vehicles, the driving range of the vehicle. In the case of property purchased by tax-exempt persons, the seller may claim the credit. The taxpayer would be ineligible for the deduction allowable under present-law section 179A for a qualified battery electric vehicle on which a credit is allowable. The provision would repeal the reduce rate of credit for vehicles purchased in 2006, permitting taxpayer to claim the full amount of credit otherwise allowable for 2006. The taxpayer would be able to carry forward unused credits for 20 years or carry unused credits back for three years (but not carried back to taxable years beginning before the January 1, 2005).

<u>Effective date</u>.–The Senate amendment is effective for property placed in service after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Modifications of deduction for refueling property (sec. 813 of Senate amendment and sec. 179A of the Code)

Present Law

Certain costs of qualified clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. Natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether comprise clean-burning fuels.

The deduction is unavailable for property placed in service after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment provision 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 $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed $1,000. 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, 2007 (before January 1, 2012 in the hydrogen refueling property). 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.

Effective date.–The Senate amendment is effective for property placed in service after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Credit for retail sale of alternative motor vehicle fuels (sec. 814 of Senate amendment)

Present Law

There is no retail credit for the sale of alternative motor vehicle fuels. However, a 52-cents-per-gallon income tax credit is allowed for alcohol fuels for 2003 and 2004 (51 cents for 2005-2007). The alcohol fuels credit may be claimed as a reduction in excise tax payments. Such tax payments generally are made before the retail level. In the case of ethanol, the Code provides a separate 10-cents-per-gallon credit for small producers.

House Bill

No provision.

Senate Amendment

The Senate amendment permits taxpayers to claim a credit equal to the gasoline gallon equivalent of 50 cents per gallon of alternative fuel sold in 2005 and 2006. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, any liquid mixture consisting of at least 85 percent methanol, and any liquid mixture consisting of at least 85 percent ethanol. The credit may be claimed for sales prior to January 1, 2007. Under the provision, the credit is part of the general business credit.

Effective date.–The Senate amendment is effective for fuel sold at retail after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Small ethanol producer credit (sec. 815 of the Senate amendment and sec. 40 of the Code)

Present Law

Small ethanol 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 is provided 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 small producer credit is part of the alcohol fuels tax credit under section 40 of the Code. 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 (sec. 38(d)(4)), the only excess credits that may be passed through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)).

House Bill

No provision.

Senate Amendment

The Senate amendment makes several modifications to the rules governing the small producer ethanol credit. First, the provision liberalizes the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the provision allows cooperatives to elect to pass through the small ethanol producer credits to its patrons. The credit is apportioned pro rata among patrons of the cooperative on the basis of the quantity or value of the business done with or for such patrons for the taxable year. An election to pass through the credit is made on a timely filed return for the taxable year and is irrevocable for such taxable year.

Third, the provision repeals the rule that includes the small producer credit in income of taxpayers claiming it. Finally, the provision 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 provision is effective for taxable years ending after date of enactment.

Conference Agreement

The conference agreement allows cooperatives to elect to pass the small ethanol producer credit through to their patrons. Specifically, the credit is to be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for such taxable year.

The amount of the credit not apportioned to patrons is included in the organization's credit for the taxable year of the organization. The amount of the credit apportioned to patrons is to be included in the patron's credit for the first taxable year of each patron ending on or after the last day of the payment period for the taxable year of the organization, or, if earlier, for the taxable year of each patron ending on or after the date on which the patron receives notice from the cooperative of the apportionment.

If the amount of the credit shown on the cooperative's return for a taxable year is in excess of the actual amount of the credit for that year, an amount equal to the excess of the reduction in the credit over the amount not apportioned to patrons for the taxable year is treated as an increase in the cooperative's tax. The increase is not treated as tax imposed for purposes of determining the amount of any tax credit or for purposes of the alternative minimum tax.

The conference agreement does not contain any of the other modifications from the Senate amendment.

Effective date.–The provision is effective for taxable years ending after date of enactment.

C. Conservation and Energy Efficiency Provisions

1. Energy efficient new homes (sec. 821 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

The provision 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 the latest standards of chapter 4 of the International Energy Conservation Code approved by the Department of Energy before the construction of such qualifying new home and any applicable Federal minimum efficiency standards for equipment.

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 specifically and primarily designed to reduce heat loss or gain, and exterior windows, including skylights, and doors) and any energy-efficient heating or cooling equipment or system 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 or manufacturer, 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, an energy performance based method, a guarantee-based method, or, in the case of a qualifying new home which is a manufactured home, by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program. Manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2) are met.

A component-based method of certification is a method which uses the applicable technical energy efficiency specifications or ratings (including product labeling requirements) for the energy efficient building envelope component or energy efficient heating or cooling equipment. The Secretary shall, in consultation with the Administrator of the Environmental Protection Agency, develop prescriptive component-based packages which are equivalent in energy performance to properties which qualify under the performance-based method. The certification under the component-based method shall be provided by a local building regulatory authority, a utility, or a home energy rating organization.

A performance-based method of certification is a method which calculates projected energy usage and cost reductions in the qualifying new home in relation to a new home heated by the same fuel type and constructed in accordance with (1) the latest standards of chapter 4 of the International Energy Conservation Code approved by the Department of Energy before the construction of such qualifying new home, and (2) any applicable Federal minimum efficiency standards for equipment. Computer software shall be used in support of a performance-based method certification under clause. Such software shall meet procedures and methods for calculating energy and cost savings in regulations promulgated by the Secretary of Energy. The certification under the performance-based method shall be provided by an individual recognized by an organization recognized by the Secretary for such purposes.

A guarantee-based method of certification is a method that guarantees in writing to the homeowner energy savings of either 30 percent or 50 percent over the 2000 International Energy Conservation Code for heating and cooling costs. The guarantee shall be provided for a minimum of 2 years and shall fully reimburse the homeowner any heating and cooling costs in excess of the guaranteed amount. Computer software shall be selected by the provider of the guarantee to support the guarantee-based method certification. Such software shall meet procedures and methods for calculating energy and cost savings in regulations promulgated by the Secretary of Energy. The certification under the guarantee-based method shall be provided by an individual recognized by an organization recognized by the Secretary for such purposes.

In prescribing regulations for performance-based and guarantee-based certification methods, the Secretary shall prescribe procedures for calculating annual energy usage and cost reductions for heating and cooling and for the reporting of the results. Such regulations shall provide that any calculation procedures be fuel neutral such that the same energy efficiency measures allow a qualifying new home to be eligible for the credit under this section regardless of whether such home uses a gas or oil furnace or boiler or an electric heat pump, and require that any computer software allow for the printing of the Federal tax forms necessary for the credit under this section and for the printing of forms for disclosure to the homebuyer. Other rules apply relating to the form of the certification and the manner in which it is provided to the buyer of the home.

In the case of a qualifying new home which is a manufactured home, certification of compliance with energy efficiency standards shall be provided by a manufactured home primary inspection agency.

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. No deduction shall be allowed for that portion of expenses for a qualifying new home otherwise allowable as a deduction for the taxable year which is equal to the amount of the credit for such taxable year.

Effective date.–The credit applies to homes whose construction is substantially completed after December 31, 2004, and which are purchased during the period beginning on December 31, 2004, and ending on December 31, 2007 (December 31, 2005 in the case of the $1,000 credit).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Energy efficient appliances (sec. 822 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

The provision provides a credit for the production of certain energy-efficient clothes washers and refrigerators. The credit equals $50 per appliance for (1) energy-efficient clothes washers produced before December 31, 2007 with a modified energy factor ("MEF") of 1.42 MEF or greater, and (2) refrigerators produced before December 31, 2005 that consume 10 percent fewer 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 (1) energy-efficient clothes washers produced before December 31, 2007 with a MEF of 1.5 or greater, and (2) refrigerators produced before December 31, 2007 that consume at least 15 percent fewer 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 for refrigerators produced before January 1, 2007 that consume at least 20 percent fewer kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. 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 $50 standard, washers that meet the $100 standard, refrigerators that meet the $50 standard, refrigerators that meet the $100 standard, and refrigerators that meet the $150 standard), only production in excess of average production for each such category during calendar years 2001-2003 would be eligible for the credit.

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 would be part of the general business credit.

Effective Date

The credit applies to appliances produced after December 31, 2004, and prior to January 1, 2008.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Residential solar hot water, photovoltaics and other energy efficient property (sec. 823 of the Senate amendment)

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 personal tax credit for energy efficient residential property.

House Bill

No provision.

Senate Amendment

The provision 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 provision also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 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. Qualified wind energy property is property that uses wind energy to generate electricity for use in a dwelling unit located in the United States and used as a principal residence by the taxpayer. 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 provision also provides a credit for the purchase of other qualified energy efficient property, as described below:

<u>Electric heat pump water heater</u> with an energy factor of at least 1.7. The maximum credit is $150 per unit.

<u>Advanced natural gas, oil, propane furnace, or hot water boiler that</u> achieves at least 95 percent annual fuel utilization efficiency. The maximum credit is $125 per unit.

<u>Advanced natural gas, oil, propane water heater</u> that has an energy factor of at least 0.80 in the standard Department of Energy test procedure. The maximum credit is $150 per unit.

<u>Natural gas, oil, propane water heater</u> that has an energy factor of at least 0.65 but less than 0.80 in the standard Department of Energy test procedure. The maximum credit is $50 per unit.

<u>Advanced main air circulating fan</u> used in a new natural gas, propane, or oil-fired furnace, including main air circulating fans that use a brushless permanent magnet motor or another type of motor which achieves similar or higher efficiency at half and full speed, as determined by the Secretary. The maximum credit is $50.

<u>Advanced combination space and water heating system</u> that has a combined energy factor of at least 0.80 and a combined annual fuel utilization efficiency (AFUE) of at least 78 percent in the standard Department of Energy test procedure. The maximum credit is $150.

<u>Combination space and water heating system</u> that has a combined energy factor of at least 0.65 but less than 0.80 and a combined annual fuel utilization efficiency (AFUE) of at least 78 percent in the standard Department of Energy test procedure. The maximum credit is $50.

<u>Geothermal heat pumps</u> that 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 expenditures after December 31, 2004, and prior to January 1, 2008.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Credit for business installation of qualified fuel cells and stationary microturbine power plants (sec. 824 of the Senate amendment and sec. 48 of the Code)

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).

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

House Bill

No provision.

Senate Amendment

The provision 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. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatts of capacity.

Additionally, the provision provides a 10 percent credit for the purchase of qualifying stationary microturbine power plants. A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components which converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less that 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt 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 December 31, 2004, and before January 1, 2008 (January 1, 2007 in the case of microturbines), under rules similar to rules of section 48(m) of the Code (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Energy efficient commercial building deduction (sec. 825 of Senate amendment)

Present Law

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

House Bill

No provision.

Senate Amendment

The provision 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 property installed in connection with the construction or reconstruction of property: (1) which is depreciable property; (2) which is located in the United States, and (3) which is the type of structure to which the Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA") is applicable. The deduction is limited to an amount equal to $2.25 per square foot of the property for which such expenditures are made. 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 building which minimally meets the requirements of Standard 90.1-2001 of ASHRAE/IESNA. Because of the requirement that, in order to qualify, a building must fall within the scope of the ASHRAE/IESNA Standard 90.1-2001, residential rental property that is less than four stories does not qualify.

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 and power costs using qualified computer software. The methods for calculation shall be fuel neutral, such that the same energy efficiency features shall qualify a building for the deduction under this subsection regardless of whether the heating source is a gas or oil furnace or boiler or an electric heat pump.

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

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that will allow the value of the deduction (determined without regard to the tax-exempt status of such entity) to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

In the case of lighting systems, until such time as the Secretary issues final regulations, a partial deduction shall be allowed for a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions.

<u>Effective date</u>.–The provision is effective for taxable years beginning after December 31, 2004 for expenditures in connection with a building whose construction is completed on or before December 31, 2009.

<u>**Conference Agreement**</u>

The conference agreement does not include the Senate amendment provision.

6. Three-year applicable recovery period for depreciation of qualified energy management devices and qualified water submetering devices (secs. 826 and 827 of the Senate amendment and sec. 168 of the Code)

Present Law

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

House Bill

No provision.

Senate Amendment

The Senate amendment provides a three-year recovery period for qualified 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 energy management device that is 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 to provide such data on at least a monthly basis to both consumers and the taxpayer.

Additionally, the Senate amendment provides a three-year recovery period for qualified 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 water submetering device that is used by the taxpayer to measure and record water usage data and to provide such data on at least a monthly basis to both consumers and the taxpayer.

Effective date.–The provision is effective for any qualified energy management device or water submetering device placed in service after December 31, 2004, and before January 1, 2008.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Energy credit for combined heat and power system property (sec. 828 of the Senate amendment and sec. 48 of the Code)

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.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a 10-percent credit for the purchase of CHP property.

CHP property is property: (1) that 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) that has an electrical capacity of not more than 15 megawatts or a mechanical energy capacity of no more than 2000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

Additionally, the Senate amendment provides that systems whose fuel source is at least 90 percent bagasse and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

Effective date.–The credit applies to property placed in service after December 31, 2004, and before January 1, 2007.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Energy efficient improvements to existing homes (sec. 829 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

The provision 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. Unused credits may be carried forward to succeeding taxable years.

A qualified energy efficiency improvement would be any energy efficiency building envelope component that is certified to meet or exceed the latest prescriptive criteria for such component in the International Energy Conservation Code approved by the Department of Energy before the installation of such component, 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 that is installed in or on a dwelling that (1) is located in the United States; (2) is owned and used by the taxpayer as the taxpayer's principal residence; (3) has not been treated as a qualifying new home for purposes of the energy-efficient new homes credit . Additionally, the original use of such component or combination of measures commences with the taxpayer, and such component or combination of measures can reasonably be expected to remain in use for at least five years.

Building envelope components are: (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 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.

In prescribing regulations for performance-based certification methods, the Secretary shall prescribe procedures for calculating annual energy usage and cost reductions for heating and cooling and for the reporting of the results. Such regulations shall provide that any calculation procedures be fuel neutral such that the same energy efficiency measures allow a qualifying new home to be eligible for the credit under this section regardless of whether such home uses a gas or oil furnace or boiler or an electric heat pump, and require that any computer software allow for the printing of the Federal tax forms necessary for the credit under this section and for the printing of forms for disclosure to the owner of the dwelling.

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 after December 31, 2004, and before January 1, 2007.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

D. Clean Coal Incentives

1. Credit for production from a clean coal technology unit (secs. 831 and 834 of Senate amendment)

Present Law

Present law does not provide a production credit for electricity generated at units that use coal as a fuel. However, 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, 2006 (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 equals 1.8 cents for 2004. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The production tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

The Senate amendment provides a production credit for electricity produced from certain units that have been retrofitted, repowered, or replaced with a clean coal technology during the ten-year period beginning on January 1, 2005. The value of the credit is 0.34 cents per kilowatt-hour of electricity produced and is indexed for inflation for calendar years after 2005.

A qualifying clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. 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.

Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) are eligible to obtain certifications from the Secretary for 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 trades are not permitted.

Effective date.–The Senate amendment is effective for production after December 31, 2004, in taxable years ending after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Investment credit for clean coal technology units (secs. 832 and 834 of Senate amendment)

Present Law

Present law does not provide an investment credit for electricity generating 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). The business energy tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

In general

The Senate amendment provides a 10-percent investment tax credit for qualified investments in 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 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 trades are not permitted.

Qualifying advanced clean coal technology units

Qualifying advanced clean coal technology units must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology, pressurized 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 SO_2, 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.

If the advanced clean coal technology unit is an advanced pulverized coal or atmospheric fluidized bed combustion technology unit, a pressurized fluidized bed combustion technology unit, or an integrated gasification combined cycle technology unit and if the unit uses a design coal with a heat content of not more than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.60 pound of carbon per kilowatt hour of electricity produced. If the advanced clean coal technology unit is an advanced pulverized coal or atmospheric fluidized bed combustion technology unit, a pressurized fluidized bed combustion technology unit, or an integrated gasification combined cycle technology unit and if the unit uses a design coal with a heat content greater than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.54 pound of carbon per kilowatt hour of electricity produced. In the case of an advanced clean coal technology unit that uses another eligible technology and if the unit uses a design coal with a heat content of not more than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.51 pound of carbon per kilowatt hour of electricity produced. In the case of an advanced clean coal technology unit that uses another eligible technology and if the unit uses a design coal with a heat content greater than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.459 pound of carbon per kilowatt hour of electricity produced.

Allocation of credits

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 4,000 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 4,000 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 4,000 megawatts of capacity, not more than 500 megawatts in total and not more than 250 megawatts in years prior to 2009 shall be allocated to units using pressurized fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 2,000 megawatts in total and not more than 1,000 megawatts in years prior to 2009 and not more than 1,500 megawatts in year prior to 2013 shall be allocated to units using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 4,000 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.

Effective date.–The Senate amendment is effective for periods after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Credit for production from advanced clean coal technology (secs. 833 and 834 of the Senate amendment)

Present Law

Present law does not provide a production credit for electricity generated at units that use coal as a fuel. However, 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, 2006 (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 equals 1.8 cents for 2004. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The production tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

In general

The Senate amendment creates 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. 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 trades are not permitted.

Value of production credit for electricity produced from qualifying advanced clean coal technology

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.[392] 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. The maximum value of the production credit from any qualifying unit during the first five years of production is $0.014 per kilowatt-hour and the minimum value is $0.001. During the second five years of production from a qualifying unit, the maximum value of the production credit is $0.0115 and the minimum value is $0.001. The value of the credit is indexed for inflation for calendar years after 2005.

Effective date.– The Senate amendment is effective for production after December 31, 2004, in taxable years ending after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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

E. Oil and Gas Provisions

1. Oil and gas production from marginal wells (sec. 841 of the Senate amendment and new sec. 45I of the Code)

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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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. In both cases, the credit is available only for production from a "qualified marginal well." A qualified marginal well is defined as domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. Production from any well during any period in which such well is not in compliance with applicable Federal pollution prevention, control, and permit requirements is not considered a qualified marginal well during such period. The maximum amount of production on which credit could be claimed is 1,095 barrels or barrel equivalents.

The credit is not available to production occurring if the reference price of oil exceeds $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.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 29 for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 29 with respect to the well. The credit is treated as a general business credit.

Effective date.–The Senate amendment is effective for production in taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement modifies the Senate amendment. The conference agreement does not include the Federal pollution prevention, control, and permit requirement provisions of the Senate amendment. The conference agreement treats the credit as part of the general business credit; however, unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year. The credit is indexed for inflation for taxable years beginning in a calendar year after 2005.

Effective date.– The provision is effective for production in taxable years beginning after December 31, 2004.

2. Natural gas gathering lines treated as seven-year property (sec. 842 of the Senate amendment and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[393] 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 and the 6th Circuit Court of Appeals have held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., seven-year recovery period).[394] The Tax Court has held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 46.0 (*i.e.*, 15-year recovery period).[395]

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a statutory seven-year recovery period and a class life of 14 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

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[393] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[394] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 T.C. 416 (1997). *Saginaw Bay Pipeline Co. v. United States*, 2003 FED App. 0259P (6th Cir.) *rev'g* 124 F. Supp. 2d 465 (E.D. Mich. 2001). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

[395] *Clajon Gas Co., L.P. v. Commissioner*, 119 T.C. 197 (2002).

transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

Effective date.–The Senate amendment is effective for property placed in service after December 31, 2004, in taxable years ending after that date. No inference is intended as to the proper treatment of natural gas gathering lines placed in service before the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Expensing of capital costs incurred for production in complying with environmental protection agency sulfur regulations for small refiners (sec. 843 of the Senate amendment and new sec. 179B of the Code)

Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions.

House Bill

No provision.

Senate Amendment

The Senate amendment permits small business refiners to immediately deduct as an expense up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). Costs qualifying for the deduction are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009.

For these purposes a small business refiner is a taxpayer who is in the business of refining petroleum products and employs not more than 1,500 employees directly in refining and has less than 205,000 barrels per day (average) of total refinery capacity. The deduction is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

Effective date.–The Senate amendment is effective for expenses paid or incurred after December 31, 2002, in taxable years ending after that date.

Conference Agreement

The conference agreement includes the Senate amendment provision. With respect to the definition of a small business refiner, the conferees intend that, in any case in which refinery through-put or retained production of the refinery differs substantially from its average daily output or refined product, capacity be measured by reference to the average daily output of refined product.

4. Credit for small refiners for production of diesel fuel in compliance with Environmental Protection Agency sulfur regulations for small refiners (sec. 844 of Senate amendment and new sec. 45H of the Code)

Present Law

Present law does not provide a credit for the production of low-sulfur diesel fuel.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. Costs qualifying for the credit are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. The taxpayer's basis in property with respect to which the credit applies is reduced by the amount of production credit claimed.

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.

For these purposes a small business refiner is a taxpayer who is in the business of refining petroleum products, employs not more than 1,500 employees directly in refining, and has less than 205,000 barrels per day (average) of total refinery capacity. The credit is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

Effective date.–The Senate amendment is effective for expenses paid or incurred after December 31, 2002, in taxable years ending after that date.

Conference Agreement

The conference agreement includes the Senate amendment provision with modification as follows. The conference agreement makes the low sulfur diesel fuel credit a qualified business credit under section 169(c). Therefore, if any portion of the credit has not been allowed to the taxpayer as a general business credit (sec. 38) for any taxable year, an amount equal to that portion may be deducted by the taxpayer in the first taxable year following the last taxable year for which such portion could have been allowed as a credit under the carryback and carryforward rules (sec. 39). With respect to the definition of a small business refiner, the conferees intend that, in any case where refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, capacity be measured by reference to the average daily output of refined product.

5. Determination of small refiner exception to oil depletion deduction (sec. 845 of the Senate amendment and sec. 613A of the Code)

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.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the current 50,000-barrel-per-day limitation to 60,000. In addition, the provision 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 may not exceed 60,000 barrels. For this purpose, the taxpayer calculates average daily production by dividing total production for the taxable year by the total number of days in the taxable year.

Effective date.–The Senate amendment is effective for taxable years ending after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Suspension of 100-percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (sec. 412 of the House bill, sec. 846 of the Senate amendment, and sec. 613A of the Code)

Present Law

Overview of depletion

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

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[396] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[397] 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.[398] 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.[399] The amount deducted generally may not exceed 100 percent

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

[397] Secs. 611-613.

[398] Sec. 613A.

[399] Sec. 613A(c).

of the net income from that property in any year (the "net-income limitation").[400] The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2006.

House Bill[401]

The provision extends the suspension of the net-income limitation for marginal wells for taxable years beginning before January 1, 2006.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment[402]

The Senate amendment extends the suspension of the net-income limitation for marginal wells for taxable years beginning before January 1, 2007.

Effective date.–Same as the House bill.

Conference Agreement

The conference agreement does not contain the House bill or Senate amendment provision.

7. Delay rental payments (sec. 847 of the Senate amendment and sec. 167 of the Code)

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 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. A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development of operations or by obtaining production. The Treasury Department has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

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[400] Sec. 613(a).

[401] The House bill predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

[402] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a number of extensions to expiring provisions.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that delay rental payments incurred in connection with the development of oil or gas 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 Senate amendment is effective for amounts paid or incurred in taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Geological and geophysical costs (sec. 848 of the Senate amendment and sec. 167 of the Code)

Present Law

Under present law, 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. Capital expenditures are not currently deductible as ordinary and necessary expenses, but are allocated to the cost of the property (sec. 263). Courts have held that geological and geophysical costs are capital, and therefore are allocable to the cost of property acquired or retained. The costs attributable to such exploration are allocable to the cost of the property acquired or retained. In the case of abandoned property, exploration expenditures are allowable as a loss when such property is abandoned.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that geological and geophysical costs incurred in connection with domestic oil and gas exploration 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 Senate amendment is effective for costs paid or incurred in taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Extension and modification of credit for producing fuel from a non-conventional source (sec. 849 of the Senate amendment and sec. 29 of the Code)

Present Law

An income tax credit is allowed for certain fuels produced from "non-conventional sources" and sold to unrelated parties. The amount of the credit is equal to $3 (generally adjusted for inflation[403]) per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States, and include: oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

The credit applies 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 applies to 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).

House Bill

No provision.

Senate Amendment

Extension of placed in service date for certain new facilities

For new wells or facilities producing qualifying fuels that are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, the credit can be claimed for production from such new facilities placed in service after December 31, 2004 and before January 1, 2007. The credit may be claimed for the three-year period beginning on the date such well or facility is placed in service. For all qualifying wells and facilities the value of the credit is $3.00 per barrel or Btu equivalent for production in 2003 and is indexed for inflation commencing with the credit amount for 2004.

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[403] The value of the section 29 credit for production in 2003 was $6.40 per barrel of oil equivalent. The $3.00 credit for gas from a tight formation is not adjusted for inflation.

Extension and modification for "refined coal"

The Senate amendment provides a credit for production of "refined coal" from facilities placed in service after December 31, 2004, and before January 1, 2007. Credit may be claimed for fuel produced during the five-year period beginning on the date such facility is placed in service. The amount of the credit is $3.00 per barrel or Btu equivalent for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. Refined coal is a fuel that is a liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A facility qualifies for the credit only if it produces refined coal that: (1) when burned emits 20 percent less SO_2 and nitrogen oxides than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2004, and (2) 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 technology unit (as defined elsewhere) is a qualifying fuel.

Expansion for "viscous oil"

The Senate amendment provides a credit for production of certain viscous oil produced at wells placed in service after December 31, 2004, and before January 1, 2007. "Viscous oil" is 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 credit may be claimed for fuel produced during the three-year period beginning on the date such well is placed in service. The amount of the credit is $3.00 per barrel or Btu equivalent for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. The Senate amendment provides that qualifying sales to related parties for consumption not in the immediate vicinity of the wellhead qualify for the credit.

Credit for coalmine methane gas

The Senate amendment provides a credit for production of "coalmine methane gas" captured or extracted from a coalmine and sold after December 31, 2004, and before January 1, 2007. The amount of the credit is $3.00 (indexed for inflation from 2002) per barrel or Btu oil for gas utilized captured or sold during the applicable period. Qualifying coalmine gas is any methane gas liberated during coal mining operations or extracted up to ten years in advance of coal mining operations as part of a specific plan to mine a coal deposit. In the case of coalmine methane gas that is captured in advance of coal mining operations, the credit is allowed only after the date the coal extraction occurs in the immediate area where the coalmine methane gas was removed. The capture or extraction of coalmine gas from coal mining operations is required to be in compliance with applicable State and Federal pollution prevention, control, and permit requirements in order to qualify for the credit.

Expansion for agricultural and animal wastes

The Senate amendment adds facilities producing liquid, gaseous, or solid fuels from agricultural and animal wastes (including such fuels when used as feedstocks) placed in service after December 31, 2004, and before January 1, 2007, to the list of qualified facilities for purposes of the non-conventional fuel credit. The credit may be claimed for fuel produced during the three-year period beginning on the date such facility is placed in service. The amount of the credit is $3.00 per barrel or Btu equivalent for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. 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.

Extension of credit for certain existing facilities

The Senate amendment extends the present law credit ($3.00 indexed for inflation from 1979) 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. For persons (or subsidiaries of such persons) engaged in furnishing electric energy, or providing telephone service, to persons in rural areas, any credit claimed for this purpose may be applied as a prepayment of any loan, debt, or other obligation to the extent provided by the Secretary of Agriculture and to the extent provided by the Secretary of Energy, as a prepayment not to exceed 50 percent of any obligation incurred pursuant to an asset purchase agreement entered into with the Secretary and dated October 7, 1988. Such credit is not considered income for these purposes.

Daily limit

Under the Senate amendment, with respect to qualifying facilities placed in service under the extended placed in service dates, a taxpayer would not be able to claim any credit for production in excess of a daily average[404] of 200,000 cubic feet of natural gas or barrel of oil equivalent (200,000 cubic feet is equivalent to approximately 35.4 barrels of oil) of such gas with respect to: (1) oil produced from shale and tar sands and (2) gas produced from geopressured brine, Devonian shale, coal seems, or a tight formation. Days before the date the project is placed in service are not taken into account in determining such average.

New phaseout adjustment

In the case of fuels sold after 2003, with the exception of fuel produced at existing facilities and for any gas from a tight formation: (1) the dollar amount of the credit is $3.00 indexed for inflation from 2002 (without regard to a phaseout adjustment), and (2) the threshold for purposes of the phaseout of the credit is increased from $23.50 to $35.00 (indexed for inflation from 2002).

General business credit

The provision adds section 29 to the list of general business credits and re-labels present section 29 of the Code as new Code section 45R.

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[404] The daily average is computed as total production divided by the total number of days the well or facility was in production during the year. Days before the date the project is placed in service are not taken into account in determining the daily average.

Study of coalbed methane gas

The Senate amendment provides that the Secretary of Treasury undertake a study of the effect of section 29 on the production of coalbed methane. The study should estimate the total amount of credit claimed annually and in aggregate related to the production of coalbed methane since the date of enactment of section 29. The study should report the annual value of the credit allowable for coalbed 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 coalbed methane that has resulted from the enactment of section 29. The study should also estimate the cost to the Federal government, in terms of the net tax benefits claimed, per thousand cubic feet of incremental coalbed methane produced annually and in aggregate since the enactment of section 29.

Effective date

In general, except as provided below, the provision is effective for fuel sold from qualifying facilities after December 31, 2004, in taxable years ending after such date.

For existing facilities, the provision is effective for fuel sold after December 31, 2002, in taxable years ending after such date.

For application of the general business credit, the provision is effective for taxable years ending after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Natural gas distribution lines treated as 15-year property (sec. 850 of the Senate amendment and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[405] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a statutory 15-year recovery period and a class life of 35 years for natural gas distribution lines.

Effective date.–The Senate amendment is effective for property placed in service after December 31, 2004, in taxable years ending after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Credit for production of Alaska natural gas (sec. 851 of Senate amendment)

Present Law

Present law does not provide a credit for conventional production of natural gas or delivery of fuels to a pipeline. However, certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

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

(2) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

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[405] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

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).

House Bill

No provision.

Senate Amendment

The provision provides a credit per million British thermal units (Btu) of natural gas for Alaska natural gas entering a pipeline[406] during the 25-year period beginning the later of January 1, 2010 or the initial date for the interstate transportation of Alaska natural gas. Taxpayers may claim the credit against both the regular and minimum tax.

The credit amount for any month is a maximum of 52 cents per million Btu of natural gas. The credit phases out as the reference price of Alaska natural gas rises above 83 cents per million Btu, at a rate of one cent of credit lost per each cent by which the reference price of Alaska natural gas exceeds 83 cents per million Btu. The credit is not available if the reference price of Alaska natural gas rises above $1.35 per million Btu. The 52-cent and 83-cent figures are indexed for inflation after 2004, with the first adjustment for calendar year 2006.[407]

The bill provides that the Secretary of Treasury calculate the reference price of Alaska natural gas as the average price of natural gas delivered in the lower 48 States less certain transportation costs and gas processing costs. Alaska natural gas is any gas derived from an area

[406] Natural gas entering a gas processing facility is not considered to have entered a pipeline. Rather, the credit applies only to pipeline quality gas at the time of entry into the pipeline.

[407] In practice, the $1.35-figure also is indexed for inflation, as $1.35 is the sum of the 52-cent credit and the 83-cent price.

The bill provides that the Secretary can compute the inflation adjustment factor for a calendar year in the fourth quarter of the preceding year. For example, the adjustment for 2006 is calculated as the 2005 GDP deflator over the 2004 GDP deflator, where the 2004 GDP deflator is the value of the GDP deflator on June 30, 2004 (as determined by the latest available revision from the Department of Commerce prior to October 1, 2004). Likewise, the 2005 deflator is the value of the GDP deflator on June 30, 2005.

of the State of Alaska lying north of 64 degrees North latitude, but not including the Alaska National Wildlife Refuge.

The credit is part of the general business credit.

Effective date.–The proposal is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Treat certain Alaska pipeline property as seven-year property (sec. 852 of the Senate amendment and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[408] . Asset class 46.0, describing assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors, are assigned a class life of 22 years and a recovery period of 15 years.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a statutory seven-year recovery period and a class life of 22 years for any Alaska natural gas pipeline. The term "Alaska natural gas pipeline" is defined as any natural gas pipeline system (including the pipe, trunk lines, related equipment, and appurtenances used to carry natural gas, but not any gas processing plant) located in the State of Alaska that has a capacity of more than 500 billion Btu of natural gas per day and is placed in service after December 31, 2012. A taxpayer who places an otherwise qualifying system in service before January 1, 2013 may elect to treat the system as placed in service on January 1, 2013, thus qualifying for the seven-year recovery period.

Effective date.–The Senate amendment is effective for property placed in service after December 31, 2004.

Conference Agreement

The conference agreement follows the Senate amendment with the following modification. In order to qualify for the seven-year recovery period, otherwise qualifying

[408] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

property must be placed in service after December 31, 2013. A taxpayer who places an otherwise qualifying system in service before January 1, 2014 may elect to treat the system as placed in service on January 1, 2014, thus qualifying for the seven-year recovery period.

Effective date.–The provision is effective for property placed in service after December 31, 2004.

13. Enhanced oil recovery credit for certain gas processing facilities (sec. 853 of the Senate amendment and sec. 43 of the Code)

Present Law

The taxpayer may claim a credit equal to 15 percent of enhanced oil recovery costs. Qualified enhanced oil recovery costs include costs of depreciable tangible property that is part of an enhanced oil recovery project, intangible drilling and development costs with respect to an enhanced oil recovery project, and tertiary injectant expenses incurred with respect to an enhanced oil recovery project. The credit is phased out when oil prices exceed a threshold amount.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that expenses in connection with the construction of any qualifying natural gas processing plant capable of processing two trillion British thermal units of Alaskan natural gas into a natural gas pipeline system on a daily basis are qualified enhanced oil recovery costs eligible for the enhanced oil recovery credit. A qualifying natural gas processing plant also must produce carbon dioxide for re-injection into a producing oil or gas field.

Effective date.–The provision is effective for costs paid or incurred in taxable years beginning after December 31, 2004.

Conference Agreement

The conference agreement follows the Senate amendment.

14. Exempt certain prepayments for natural gas from tax-exempt bond arbitrage rules (sec. 854 of the Senate amendment and secs. 141 and 148 of the Code)

Present Law

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

On August 4, 2003, the Treasury Department issued final regulations deeming to be customary, and not in violation of the arbitrage rules, certain prepayments for natural gas and electricity.[409] Generally, a qualified prepayment under the regulations requires that 90 percent of the natural gas or electricity purchased with the prepayment be used for a qualifying use. Generally, natural gas is used for a qualifying use if it is to be (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, however, gas used to produce electricity for sale is not included under this provision (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric service area customers of the issuing utility, (3) used by the issuing municipal utility to produce electricity that will be sold to a utility owned by a governmental person and furnished to the service area retail electric customers of the purchaser, (4) sold to a utility that is owned by a governmental person if the requirements of (1), (2) or (3) are satisfied by the purchasing utility (treating the purchaser as the issuing utility) or (5) used to fuel the pipeline transportation of the prepaid gas supply. Electricity is used for a qualifying use if it is to be (1) furnished to retail service area electric customers of the issuing municipal utility or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser. Both governmental gas and electric utilities may take advantage of this regulatory provision.

State and local bonds may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or the debt is repaid with governmental funds. Private activity bonds are bonds where the State or local government serves as a conduit providing financing to private businesses or individuals. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes permitted by the Code. Section 141(D) of the Code provides that the term “private activity bond” includes any bond issued as part of an issue if the amount of the proceeds of the issue which are to be used (directly or indirectly) for the acquisition by a governmental unit of nongovernmental output property exceeds the lesser of five percent of such proceeds or $5 million. “Nongovernmental output property” generally means any property (or interest therein) which before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (other than a facility for the furnishing of water). An exception applies to output property which is to be used in connection with an output facility 95 percent or more of the output of which will be consumed in (1) a qualified service area of the governmental unit acquiring the property, or (2) a qualified annexed area of such unit.

[409] Treas. Reg. sec. 1.148-1(e)(2)(iii).

House Bill

No provision.

Senate Amendment

In general

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

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

Adjustments

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

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

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

Intentional acts

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

Definition of service area

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

Ruling request for higher prepayment amounts

Upon written request, the Secretary may allow an issuer to prepay for an amount of gas greater than that allowed by the safe harbor based on objective evidence of growth in gas consumption or population that demonstrates that the amount permitted by the exception is insufficient.

Nongovernmental output property restrictions

A qualified natural gas supply contract as defined in the Senate amendment is not nongovernmental output property for purposes of subsection (d) of section 141. Subsection (d) of section 141 does not apply to prepayment contracts for natural gas or electricity that either under the Treasury regulations or statutory safe harbor are not investment-type property for purposes of the arbitrage rules under section 148. No inference is intended regarding the application of subsection 141(d) to prepayment contracts not covered by the statutory safe harbor or Treasury regulations.

Effective date

The provision is effective for obligations issued after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Electric Utility Restructuring and Reliability Provisions

1. Modification to special rules for nuclear decommissioning costs (sec. 855 of the Senate amendment and sec. 468A of the Code)

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.[410]

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").[411] 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

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[410] 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.

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

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 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.[412] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[413]

<u>Nonqualified nuclear decommissioning funds</u>

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.[414] 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.

<u>House Bill</u>

No provision.

<u>Senate Amendment</u>

<u>Repeal of cost of service requirement</u>

The Senate amendment 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.

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[412] Treas. reg. sec. 1.468A-6.

[413] Treas. reg. sec. 1.468A-6(f).

[414] These funds are generally referred to as "nonqualified funds."

Permit contributions to a qualified fund for pre-1984 decommissioning costs

The Senate amendment also repeals the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant's decommissioning costs incurred during the period that the qualified fund is in existence (generally post-1984 decommissioning costs). Thus, any taxpayer is permitted to accumulate an amount sufficient to cover the present value of 100 percent of a nuclear powerplant's estimated decommissioning costs in a qualified fund. The Senate amendment does not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

Exception to ruling amount for certain decommissioning costs

The Senate amendment 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 section 468A(d)(2)(A) is not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).[415] 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.[416] If a qualified fund that has received amounts under this rule is transferred to another person, the transferor will be permitted a deduction for any remaining deductible amounts at the time of transfer.

[415] 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).

[416] 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.

Contributions to a qualified fund after useful life of powerplant

The Senate amendment also allows deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments are permitted to the extent they do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Clarify treatment of transfers of qualified funds

The Senate amendment 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 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

Effective date.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Treatment of certain income of electric cooperatives (sec. 856 of the Senate amendment and sec. 501 of the Code)

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 Internal Revenue Service 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 ownership; (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).[417]

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

[417] Announcement 96-24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996-16 I.R.B. 35.

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).

<u>Taxation of electric cooperatives exempt from subchapter T</u>

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. [418]

<u>Tax exemption of rural electric cooperatives</u>

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

[418] *See* Rev. Rul. 83-135, 1983-2 C.B. 149.

principles described above in order to qualify for tax exemption under section 501(c)(12).[419] 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.

The receipt by a rural electric cooperative of contributions in aid of construction and connection charges is taken into account for purposes of applying the 85-percent test.

Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under section 511.

House Bill

No provision.

Senate Amendment

Treatment of income from open access transactions

The Senate amendment 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 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); [420]

(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

[419] Rev. Rul. 72-36, 1972-1 C.B. 151.

[420] Under the Senate amendment, references to FERC are treated as including references to the Public Utility Commission of Texas or the Rural Utilities Service.

(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 Senate amendment 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 Senate amendment 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 Senate amendment 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 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 Senate amendment 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 Senate amendment 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 bill 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 Senate amendment 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 Senate amendment 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 Senate amendment 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

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

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications.

Treatment of income from open access transactions

Income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by FERC or under an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control–but not ownership–of transmission facilities)[421] is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

In addition, income is excluded for purposes of the 85-percent test if it is received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy distribution services or ancillary services, provided such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the cooperative: (1) to end-users who are served by distribution facilities not owned by the cooperative or any of its members; or (2) generated by a generation facility that is not owned or leased by the cooperative or any of its members and that is directly connected to distribution facilities owned by the cooperative or any of its members.

Treatment of cancellation of indebtedness income from prepayment of certain loans

The conference agreement does not include this provision.

Treatment of income from load loss transactions

For purposes of this provision, the "start-up year" is defined in the conference agreement as the first year that the cooperative offers nondiscriminatory open access or, if later and at the election of the cooperative, the calendar year that includes the date of enactment of this provision.

Effective date

The conference agreement provision is effective for taxable years beginning after the date of enactment and before January 1, 2007.

3. Dispositions of transmission property to implement Federal Energy Regulatory Commission restructuring policy (no reinvestment obligation) (sec. 857 of the Senate amendment and sec. 451 of the Code)

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.

[421] Under the conference agreement, references to FERC are treated as including references to the Public Utility Commission of Texas.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 any stock or partnership interest in a corporation or partnership whose principal trade or business consists of providing electrical services. In order to qualify, the transaction must occur before January 1, 2008 and the sale or disposition must be to an independent transmission company.

In general, an independent transmission company is defined as: (1) a regional transmission organization approved by the Federal Entergy Regulatory Commission ("FERC"); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2008; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization.

An electing taxpayer is required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in such manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years. Finally, the provision provides that the installment sale rules shall not apply to any qualifying electric transmission transaction for which a taxpayer elects the application of this provision.

Effective date.–The Senate amendment is effective for transactions occurring after December 31, 2004.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications. The provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[422] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain shall be recognized to the extent of such excess in the year of the qualifying electric transmission transaction. Any remaining realized gain is recognized ratably over the eight-year period.

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[422] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

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 company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider[423] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider 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 jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the proposal permits the reinvestment property to be purchased by any member of the affiliated group (in lieu of the taxpayer).

If a taxpayer elects the application of the provision, then the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain eligible for the provision is realized, attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary of the Treasury is notified by the taxpayer of the reinvestment property or an intention not to reinvest.

An electing taxpayer 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.[424] In addition, an electing taxpayer is required to attach a statement that identifies the reinvestment property in the manner as the Secretary shall prescribe.

Effective date.–The provision is effective for transactions occurring after the date of enactment, in taxable years ending after such date.

[423] For example, a regional transmission organization, an independent system operator, or and independent transmission company.

[424] The provision also provides that the installment sale rules shall not apply to any qualifying electric transmission transaction for which a taxpayer elects the application of this provision.

G. Additional Provisions

1. GAO Study (sec. 897 of the Senate amendment)

Present Law

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

House Bill

No provision.

Senate Amendment

The Senate amendment directs the Comptroller General to undertake an ongoing analysis of the (1) effectiveness of the amendment's alternative motor vehicles, fuel incentives, and conservation and energy efficiency provisions and (2) the recipients of the tax benefits contained in those provisions, including an identification of the recipients by income and other appropriate measurements. The analysis must quantify the effectiveness of the provisions by examining and comparing the Federal Government's forgone revenue to the aggregate amount of energy actually conserved and tangible environmental benefits gained as a result of the provisions.

The Senate amendment directs the Comptroller General to report the required analysis to Congress not later than December 31, 2004 and annually thereafter.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels (sec. 898 of the Senate amendment and secs. 4041, 4042, 6421, and 6427 of the Code)

Present Law

Under present law, diesel fuel used in trains is subject to a 4.4-cents-per gallon excise tax. Revenues from 4.3 cents per gallon of this excise tax are retained in the General Fund of the Treasury. The remaining 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.

Similarly, fuels used in barges operating on the designated inland waterways system are subject to a 4.3-cents-per-gallon General Fund excise tax. This tax is in addition to the 20.1-cents-per-gallon tax rates that are imposed on fuels used in these barges to fund the Inland Waterways Trust Fund and the Leaking Underground Storage Tank Trust Fund.

In both cases, the 4.3-cents-per-gallon excise tax rates are permanent. The LUST Trust Fund tax is scheduled to expire after March 31, 2005.

House Bill

No provision.

Senate Amendment

The 4.3-cents-per-gallon General Fund excise tax rate on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system is repealed. The 0.1 cent per gallon tax for the LUST Trust Fund is unchanged by the provision.

Effective date.–The Senate amendment is effective on October 1, 2004.

Conference Agreement

The conference agreement repeals the 4.3-cents-per-gallon General Fund excise tax rates on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system over a prescribed phase-out period. The 4.3-cent-per-gallon tax is reduced by 1 cent per gallon for the first six months of calendar year 2005 (January 1, 2005 through June 30, 2005). The reduction is 2 cents per gallon from July 1, 2005 through December 31, 2006, and 4.3 cents/gallon thereafter. Thus, the tax would be fully repealed effective January 1, 2007. The 0.1 cent per gallon tax for the LUST Trust Fund is unchanged by the provision.

Effective date.–The provision is effective on January 1, 2005.

3. Increase tax limitation on use of business energy credits (secs. 851(c) and 899A of the Senate amendment, and sec. 38 of the Code)

Present Law

Generally, business tax credits may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability). Credits in excess of the limitation may be carried back one year and carried over for up to 20 years.

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

House Bill

No provision.

Senate Amendment

The Senate amendment treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to (1) the Alaska natural gas credit, (2) for taxable years beginning after December 31, 2004, the alcohol fuels credit determined under section 40; and (3) the section 45 credit for electricity produced from a facility (placed in service after the date of enactment) during the first four years of production beginning on the date the facility is placed in service.

Effective date.–The provision is effective for taxable years ending after the date of enactment of the Act.

Conference Agreement

The conference agreement includes the provision in the Senate amendment relating to the credits under sections 40 and 45.

4. Transmission property treated as fifteen-year property (sec. 899C of the Senate amendment and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56. Assets used in the transmission and distribution of electricity for sale and related land improvements are assigned a 20-year recovery period and a class life of 30 years.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a statutory 15-year recovery period and a class life of 30 years for certain assets used in the transmission of electricity for sale and related land improvements. For purposes of the provision, section 1245 property used in the transmission of electricity for sale at 69 kilovolts and above, the original use[425] of which commences after the date of enactment, will qualify for the new recovery period.

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[425] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, if on August 11, 2005, a taxpayer buys from RCM for $200,000 transmission lines that have been previously used by RCM. Subsequent to the purchase, the taxpayer makes an expenditure on the property of $50,000 of the type that must be capitalized. Regardless of whether the $50,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as

Effective date.–The Senate amendment is effective for property placed in service after the date of enactment and prior to July 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Qualifying pollution control equipment credit (sec. 899B of the Senate amendment)

Present Law

The investment credit is the sum of three credits: (1) the rehabilitation credit, (2) the energy credit, and (3) the reforestation credit.[426] The investment credit is part of the general business credit.[427]

House Bill

No provision.

Senate Amendment

The Senate amendment adds a credit for qualifying pollution control equipment to the investment credit. The qualifying pollution control equipment credit provides a 15-percent tax credit for qualifying pollution control equipment placed-in-service at a qualifying facility during the taxable year. Qualifying pollution control equipment means any technology that is installed in or on a qualifying facility to reduce air emissions of any pollutant regulated by the Environmental Protection Agency under the Clean Air Act. A qualifying facility is a facility that produces not less than 1,000,000 gallons of ethanol during the taxable year. A qualifying facility includes any facility that produces ethanol. For depreciation purposes, the basis of qualifying pollution control equipment would be reduced by 50 percent of the value of the credit.

Effective date.–The credit would be available for property placed-in-service after December 31, 2003, in taxable years ending after such date.[428]

Conference Agreement

The conference agreement does not include the Senate amendment.

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satisfying the "original use" requirement and would be eligible for the reduced recovery period. No part of the $200,000 purchase price qualifies for the reduced recovery period.

[426] Sec. 46.

[427] Sec. 38(b)(1).

[428] Rules similar to the 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) apply.

TITLE X – REVENUE PROVISIONS

A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation

1. Tax treatment of expatriated entities and their foreign parents (sec. 601 of the House bill, sec. 441 of the Senate amendment, and new sec. 7874 of the Code)

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

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

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

U.S. tax treatment of inversion transactions

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

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

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

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

House Bill

The bill applies special tax rules to corporations that undertake certain defined inversion transactions. For this purpose, an inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (i.e., the "expanded affiliated group") does not conduct substantial business activities in the entity's country of incorporation compared to the total worldwide business activities of the expanded affiliated group.

In such a case, any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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

Under the provision, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

Effective date.–The provision applies to taxable years ending after March 4, 2003.

Senate Amendment

In general

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

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[429] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[430]

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

[430] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated

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

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

<u>Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership</u>

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

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the

investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.

extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

The 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to taxpayers related to the inverted entity. In addition, the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers.

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

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Partnership transactions

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

Effective date

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

Conference Agreement

The conference agreement follows the House bill and Senate amendment with modifications.

In general

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

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan[431] or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[432]

In determining whether a transaction meets the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority

[431] Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

[432] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions.

to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

Under the proposal, inversion transactions include certain partnership transactions. Specifically, the proposal applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" proposals apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

Effective date

The provision applies to taxable years ending after March 4, 2003.

2. Excise tax on stock compensation of insiders in expatriated corporations (sec. 602 of the House bill, sec. 443 of the Senate amendment, and secs. 162(m), 275(a), and new sec. 4985 of the Code)

Present Law

The income taxation of a nonstatutory[433] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[434] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.[435]

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

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

House Bill

In general

Under the House bill, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The provision imposes a 15-percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified

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

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

[435] Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

Disqualified individuals

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[436] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[437] directors, and 10-percent-or-greater owners of private and publicly-held corporations.

Application of excise tax

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined in the bill) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction as previously defined in the bill.

Specified stock compensation

Specified stock compensation subject to the excise tax includes any payment[438] (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether the specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction.

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

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

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

Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

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

The excise tax applies to any specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the inversion transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable 12-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, tax-sheltered annuity, simplified employee pension, or SIMPLE. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

Determination of amount subject to tax

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

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants or other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Secretary, that takes into account (1) the stock price at the valuation date; (2) the exercise price under the option; (3) the remaining term of the option; (4) the volatility of the underlying stock and the expected dividends on it; and (5) the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable). It is expected that the Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the guidance issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the provision. Pending the issuance of guidance, it is intended that taxpayers can rely on the guidance issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

Other rules

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

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

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

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

Effective date

The provision is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

Senate Amendment

The Senate amendment follows the House bill except that excise tax is equal to 20 percent of the value of the specified stock compensation. Under the Senate amendment, the excise tax does not apply to executives of the expanded affiliated group.

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

Conference Agreement

The conference agreement follows the House bill except that the excise tax is imposed at a rate equal to the maximum rate of tax on the adjusted net capital gain of an individual (i.e., the rate of the excise tax would be 15 percent for 2005 through 2008 and 20 percent for taxable years beginning after December 31, 2008).

3. Reinsurance of U.S. risks in foreign jurisdictions (sec. 603 of the House bill, sec. 444 of the Senate amendment, and sec. 845(a) of the Code)

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[439] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[440] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

House Bill

The bill clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The bill authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[441] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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

Effective date.–The provision is effective for any risk reinsured after the date of enactment of the provision.

Senate Amendment

The Senate amendment is the same as the House bill.

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

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[439] Sec. 845(a).

[440] *See* S. Rep. No. 97-494, 97th Cong., 2d Sess., 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

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

Conference Agreement

The Conference agreement follows the House bill.

4. Revision of tax rules on expatriation of individuals (sec. 604 of the House bill, sec. 442 of the Senate amendment, and secs. 877, 2107, 2501 and 6039G of the Code)

Present Law

In general

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[442] with a principal purpose of avoiding U.S. taxes, the individuals is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income[443] at the rates applicable to U.S. citizens for the 10-year period.

An individual who relinquishes citizenship or terminates residency is treated as having done so with a principal purpose of tax avoidance and is generally subject to the alternative tax regime if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[444]

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[442] Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty).

[443] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[444] The income tax liability and net worth thresholds under section 877(a)(2) for 2004 are $124,000 and $622,000, respectively. *See* Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

Certain categories of individuals (*e.g.*, dual residents) may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the test above). Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets.

Gift tax rules with respect to expatriates

Special gift tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the rules above). The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination.

Information reporting

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of expatriation. However, this information is only required once.

House Bill

In general

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination.[445]

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[445] These provisions reflect recommendations contained in Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003.

Objective rules for the alternative tax regime

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (*e.g.*, tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[446] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[447] and individuals with minimal prior physical presence in the United States,[448] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

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[446] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

[447] An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

[448] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

Imposition of gift tax with respect to stock of certain closely held foreign corporations

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (*e.g.,* whether issued originally to the donor, purchased, or received as a gift or bequest).

Annual return

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

Effective date

The provision applies to individuals who relinquish citizenship or terminate long-term residency after June 3, 2004.

Senate Amendment

In general

The provision generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2002.

Individuals covered

Under the provision, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Election to be treated as a U.S. citizen

Under the provision, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Date of relinquishment of citizenship

Under the provision, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon expatriation or residency termination

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the provision. Regulatory authority is granted to the Treasury to except other types of property from the provision.

Under the provision, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Retirement plans and similar arrangements

Subject to certain exceptions, the provision applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[449] However, the provision contains a special rule for an interest in a "qualified retirement plan." For purposes of the provision, a "qualified retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the provision, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

Deferral of payment of tax

Under the provision, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

[449] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Interests in trusts

Under the provision, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these provision. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.–If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.–If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The provision provides a coordination rule with the present-law alternative tax regime. Under the provision, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after February 5, 2003.

Treatment of gifts and inheritances from a former citizen or former long-term resident

Under the provision, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Information reporting

The provision provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the provision.

Immigration rules

The provision amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the provision's expatriation tax provisions (regardless of the subjective motive for expatriating). For this purpose, the provision permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the provision would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this provision.

Effective date

The provision generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after February 5, 2003. The provisions relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after February 5, 2003, whose expatriation or residency termination occurs on or after such date. The provisions relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

Conference Agreement

The conference agreement follows the House bill.

5. Reporting of taxable mergers and acquisitions (sec. 605 of the House bill, sec. 445 of the Senate amendment, and new sec. 6043A of the Code)

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).[450]

House Bill

Under the bill, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

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[450] Recently issued temporary regulations under section 6043 (relating to information reporting with respect to liquidations, recapitalizations, and changes in control) impose information reporting requirements with respect to certain taxable inversion transactions, and proposed regulations would expand these requirements more generally to taxable transactions occurring after the proposed regulations are finalized.

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[451]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements are extended to failures to comply with the requirements set forth under this bill.

Effective date.–The provision is effective for acquisitions after the date of enactment.

Senate Amendment

Same as the House bill.

Conference Agreement

The conference agreement follows both the House bill and the Senate amendment.

6. Studies (sec. 606 of the House bill)

Present Law

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

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[451] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Treasury Secretary.

Under section 482, the Treasury Secretary is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's-length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration of the arm’s-length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party transactions.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

House Bill

The bill requires the Treasury Secretary to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provisions of this bill on inversion transactions.

Effective date.–The tax treaty study required under the provision is due no later than June 30, 2005. The transfer pricing study required under the provision is due no later than June 30, 2005. The inversions study required under the provision is due no later than December 31, 2005.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except the inversions study required under the provision is due no later than December 31, 2006.

B. Provisions Relating to Tax Shelters

1. Penalty for failure to disclose reportable transactions (sec. 611 of the House bill, sec. 402 of the Senate amendment, and new sec. 6707A of the Code)

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[452]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[453] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[454]

The second category is any transaction that is offered under conditions of confidentiality. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[455]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[456]

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[452] On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

[453] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[454] Treas. Reg. sec. 1.6011-4(b)(2).

[455] Treas. Reg. sec. 1.6011-4(b)(3).

[456] Treas. Reg. sec. 1.6011-4(b)(4).

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[457]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[458] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[459]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[460]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure can jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[461]

House Bill

In general

The House bill creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty

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457 Treas. Reg. sec. 1.6011-4(b)(5). Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

458 The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $250 million or more in gross assets.

459 Treas. Reg. sec. 1.6011-4(b)(6). Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

460 Treas. Reg. sec. 1.6011-4(b)(7).

461 Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. Regulations under sections 6662 and 6664 provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The House bill does not define the terms "listed transaction"[462] or "reportable transaction," nor does it explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the House bill authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner or his delegate can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to judicially appeal a refusal to rescind a penalty.[463] The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

Effective date

The House bill provision is effective for returns and statements the due date for which is after the date of enactment.

Senate Amendment

In general

The Senate amendment is the same as the House bill, with certain modifications.

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[462] The House bill provides that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

[463] This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).

Transactions to be disclosed

Like the House bill, the Senate amendment does not define the terms "listed transaction" or "reportable transaction" but, rather, authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

Under the Senate amendment, the penalty for failing to disclose a reportable transaction generally is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction).

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,[464] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The provision applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid). In addition, the Secretary is required to make public the name of any person that is required to pay a penalty for failing to

[464] A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction, or a transaction that lacks economic substance), as well as the amount of such penalty.

Effective date

The Senate amendment provision is effective for returns and statements the due date for which is after the date of enactment.

Conference Agreement

The conference agreement follows the House bill, with the following modifications.

In determining whether to rescind (or abate) the penalty for failing to disclose a reportable transaction on the grounds that doing so would promote compliance with the tax laws and effective tax administration, the conferees intend that the IRS Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

In addition, the conference agreement provides that a public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction or a non-disclosed reportable avoidance transaction) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. This requirement applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid). However, the taxpayer is only required to report the penalty one time. The conference agreement further provides that this requirement also applies to a public entity that is subject to a gross valuation misstatement penalty under section 6662(h) attributable to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction.

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 612 of the House bill, sec. 403 of the Senate amendment, and new sec. 6662A of the Code)

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[465] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[466]

Special rules apply with respect to tax shelters.[467] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[468] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[469]

House Bill

In general

The House bill modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[470] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.

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[465] Sec. 6662.

[466] Sec. 6662(d)(2)(B).

[467] Sec. 6662(d)(2)(C).

[468] Sec. 6664(c).

[469] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[470] The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[471] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[472] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item)

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[471] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

[472] *See* the previous discussion regarding the penalty for failing to disclose a reportable transaction.

is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[473] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[474] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction.–A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[475] Participation in the "management" of a transaction

[473] Under the House bill, the term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[474] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[475] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement upon which a penalty is imposed under the House bill is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under the House bill shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective date

The House bill provision is effective for taxable years ending after the date of enactment.

Senate Amendment

In general

The Senate amendment is the same as the House bill, with certain modifications.

Disclosed transactions

The Senate amendment is the same as the House bill with regard to accuracy-related penalties for understatements attributable to an adequately disclosed listed transaction or reportable avoidance transaction.

Undisclosed transactions

Like the House bill, the Senate amendment provides that a taxpayer is subject to an increased accuracy-related penalty equal to 30 percent of the understatement, and the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), if the taxpayer does not adequately disclose the transaction.

Under the Senate amendment, a public entity that is required to pay the 30-percent penalty also must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

The Senate amendment also provides that, once the 30-percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this provision and the reasons for the compromise.

Disqualified tax advisor

The Senate amendment provides that a disqualified tax advisor also includes ad advisor who has an arrangement with respect to the transaction which provides that contractual disputes between the taxpayer and the advisor are to be settled by arbitration or which limits damages by reference to fees paid to the advisor for such transaction.

Determination of the understatement amount

The Senate amendment is the same as the House bill with regard to determining the amount of an understatement that is subject to this provision.

Strengthened reasonable cause exception

The Senate amendment is the same as the House bill with regard to the reasonable cause exception to accuracy-related penalties under this provision.[476]

Coordination with other penalties

The Senate amendment is the same as the House bill with regard to coordination between the penalty imposed under this provision and other penalties.

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[476] Under the Senate amendment, the term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

Effective date

The Senate amendment provision is effective for taxable years ending after the date of enactment.

Conference Agreement

The conference agreement follows the House bill, except the conference agreement also provides that any understatement upon which a penalty is imposed under the conference agreement is not subject to the valuation misstatement penalties under sections 6662(e) or 6662(h).

3. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 613 of the House bill, sec. 406 of the Senate amendment, and sec. 7525 of the Code)

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

House Bill

The House bill modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective date.–The House bill provision is effective with respect to communications made on or after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

4. Statute of limitations for unreported listed transactions (sec. 614 of the House bill, sec. 416 of the Senate amendment, and sec. 6501 of the Code)

Present Law

In general, the Code requires that taxes be assessed within three years[477] after the date a return is filed.[478] If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[479] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[480]

House Bill

The House bill extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[481] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject to the extended statute of limitations.[482]

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[477] Sec. 6501(a).

[478] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[479] Sec. 6501(e).

[480] Sec. 6501(c).

[481] The term "listed transaction" has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

[482] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this provision does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the provision's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

Effective date.–The House bill provision is effective for taxable years with respect to which the period for assessing a deficiency did not expire before the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

5. Disclosure of reportable transactions by material advisors (secs. 615 and 616 of the House bill, secs. 407 and 408 of the Senate amendment, and secs. 6111 and 6707 of the Code)

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[483] A "tax shelter" means any investment with respect to which the tax shelter ratio[484] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and involving at least five investors).[485]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[486]

In general, a transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[487] or

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[483] Sec. 6111(a).

[484] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[485] Sec. 6111(c).

[486] Sec. 6111(d).

[487] Treas. Reg. sec. 301.6111-2(b)(2).

(2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[488] Certain exceptions are provided with respect to the second category of transactions.[489]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[490]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[491] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

House Bill

Disclosure of reportable transactions by material advisors

The House bill repeals the present law rules with respect to registration of tax shelters. Instead, the House bill requires each material advisor with respect to any reportable transaction (including any listed transaction)[492] to timely file an information return with the Secretary (in

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[488] Treas. Reg. sec. 301.6111-2(b)(3).

[489] Treas. Reg. sec. 301.6111-2(b)(4).

[490] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

[491] Sec. 6707.

[492] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[493]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income for such assistance or advice in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

Penalty for failing to furnish information regarding reportable transactions

The House bill repeals the present-law penalty for failure to register tax shelters. Instead, the House bill imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[494] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.[495] All

[493] *See* the previous discussion regarding the disclosure requirements under new section 6707A.

[494] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

[495] The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.

or part of the penalty may be rescinded only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to judicially appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

Effective date

The House bill provision requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The House bill provision imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment also includes in the definition of a "material advisor" any person who provides material aid, assistance, or advice with respect to insuring any reportable transaction (and who derives gross income for such assistance or advice in excess of the amounts specified in the House bill).

Conference Agreement

The conference agreement follows the Senate amendment.

6. Investor lists and modification of penalty for failure to maintain investor lists (secs. 615 and 617 of the House bill, secs. 407 and 409 of the Senate amendment, and secs. 6112 and 6708 of the Code)

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[496] Recently issued regulations under section 6112 contain rules

[496] Sec. 6112.

regarding the list maintenance requirements.[497] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[498]

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[499] A material advisor is defined as any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[500] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[501]

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.[502]

Penalty for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

House Bill

Investor lists

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[497] Treas. Reg. sec. 301.6112-1.

[498] A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

[499] Treas. Reg. sec. 301.6112-1(c)(1).

[500] Treas. Reg. sec. 301.6112-1(c)(2) and (3).

[501] Treas. Reg. sec. 301.6112-1(b).

[502] Sec. 6112(c)(2).

Each material advisor[503] with respect to a reportable transaction (including a listed transaction)[504] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[505]

Effective date

The House bill provision requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment. The House bill provision imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill. In addition, the Senate amendment clarifies that, for purposes of section 6112, the identity of any person is not privileged under the common law attorney-client privilege (or, consequently, the section 7525 federally authorized tax practitioner confidentiality provision).

Effective date.–The Senate amendment provision clarifying that the identity of any person is not privileged for purposes of section 6112 is effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

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[503] The term "material advisor" has the same meaning as when used in connection with the requirement to file an information return under section 6111.

[504] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

[505] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

Conference Agreement

The conference agreement follows the House bill.

7. Penalty on promoters of tax shelters (sec. 618 of the House bill, sec. 415 of the Senate amendment, and sec. 6700 of the Code)

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[506] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

House Bill

The House bill modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

Effective date.–The House bill provision is effective for activities occurring after the date of enactment.

Senate Amendment

The Senate amendment modifies the penalty amount to equal 100 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to (1) each instance of any activity that involves a statement (including a gross valuation overstatement) regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent

[506] Sec. 6700.

as to any material matter, (2) each instance in which income was derived from such activity, and (3) each person who participated in such activity. In addition, the Senate amendment imposes joint and several liability upon all persons who are subject to a penalty for such activity. The Senate amendment also provides that the payment of a penalty under this provision, or the payment of any amount to settle or avoid the imposition of such a penalty, is not deductible for tax purposes.

Effective date.–The Senate amendment provision is effective for activities occurring after the date of enactment.

Conference Agreement

The conference agreement follows the House bill.

8. Penalty for aiding and abetting the understatement of tax liability (sec. 419 of the Senate amendment and sec. 6701 of the Code)

Present Law

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the scope of this penalty in several ways. First, it applies the penalty to aiding or assisting with respect to tax liability. Second, it applies the penalty to each instance of aiding or abetting. Third, it increases the amount of the penalty to a maximum of 100 percent of the gross income derived (or to be derived) from the aiding or abetting. Fourth, if more than one person is liable for the penalty, all such persons are jointly and severally liable for the penalty. Fifth, the penalty, as well as amounts paid to settle or avoid the imposition of the penalty, is not deductible for tax purposes.

Effective date.–The Senate amendment provision is effective for activities after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Modifications of substantial understatement penalty for nonreportable transactions (sec. 619 of the House bill, sec. 405 of the Senate amendment, and sec. 6662 of the Code)

Present Law

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[507]

House Bill

The House bill modifies the definition of "substantial" for corporate taxpayers. Under the House bill, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.

Effective date.--The House bill provision is effective for taxable years beginning after date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill with regard to modifying the definition of "substantial" for corporate taxpayers.

In addition, the Senate amendment elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment.

The Senate amendment also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

[507] Sec. 6662(a) and (d)(1)(A).

Conference Agreement

The conference agreement follows the House bill, except the conference agreement also modifies the requirement of the Secretary to prescribe a list of positions that do not have substantial authority, and authorizes (but does not require) the Secretary to publish such list.

10. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions (sec. 620 of the House bill, sec. 410 of the Senate amendment, and sec. 7408 of the Code)

Present Law

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[508]

House Bill

The House bill expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[509] and the keeping of lists of investors by material advisors.[510] Thus, under the House bill, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective date.–The House bill provision is effective on the day after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment also permits injunctions to be sought with respect to violations of any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Conference Agreement

The conference agreement follows the Senate amendment.

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[508] Sec. 7408.

[509] Sec. 6707, as amended by other provisions of this bill.

[510] Sec. 6708, as amended by other provisions of this bill.

11. Penalty on failure to report interests in foreign financial accounts (sec. 621 of the House bill, sec. 412 of the Senate amendment, and sec. 5321 of Title 31, United States Code)

Present Law

The Secretary must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[511] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[512] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[513]

On April 26, 2002, the Secretary submitted to the Congress a report on these reporting requirements.[514] This report, which was statutorily required,[515] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary to the Congress by October 26, 2002.

House Bill

The House bill adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

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[511] 31 U.S.C. sec. 5314.

[512] 31 U.S.C. sec. 5321(a)(5).

[513] 31 U.S.C. sec. 5322.

[514] *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001,* April 26, 2002.

[515] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

Effective date.–The House bill provision is effective with respect to failures to report occurring on or after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except the maximum additional civil penalty for a non-willful act is up to $10,000. In addition, the Senate amendment increases the present-law penalty for willful behavior to the greater of $100,000 or 50 percent of the amount of the transaction or account.

Effective date.–The Senate amendment provision is effective with respect to failures to report occurring on or after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

12. Regulation of individuals practicing before the Department of the Treasury (sec. 622 of the House bill, sec. 414 of the Senate amendment, and sec. 330 of Title 31, United States Code)

Present Law

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[516] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

House Bill

The House bill makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the House bill expressly permits censure as a sanction. Second, the House bill permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

[516] 31 U.S.C. sec. 330.

The House bill also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective date.–The House bill modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill (except for several technical drafting modifications).

Effective date.–The Senate amendment modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

13. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds (sec. 631 of the House bill, sec. 461 of the Senate amendment, and secs. 305 and 1286 of the Code)

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) whereby if the right to receive income is transferred without an accompanying transfer of the underlying property, the transfer is not respected. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[517]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed

[517] *Helvering v. Horst*, 311 U.S. 112 (1940).

below).[518] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[519]

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[520] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[521] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[522] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate the taxpayer's basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[523] Special rules

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[518] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[519] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

[520] Sec. 1286.

[521] Sec. 1286(e).

[522] Sec. 1286(a).

[523] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases the basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[524]

Stripped preferred stock

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[525] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[526] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[527]

House Bill

The House bill authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The House bill applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

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[524] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[525] Sec. 305(e)(5).

[526] Sec. 305(e)(1).

[527] Sec. 305(e)(3).

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under the House bill would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,[528] *modifying and superceding* Rev. Proc. 2002-16.[529]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

Effective date.–The House bill provision is effective for purchases and dispositions occurring after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

14. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends (sec. 632 of the House bill, sec. 456 of the Senate amendment, and sec. 901 of the Code)

Present Law

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

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

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[528] 2002-43 I.R.B. 753.

[529] 2002-9 I.R.B. 572.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

House Bill

The House bill expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The House bill does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The House bill also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the House bill. In addition, the House bill authorizes the Treasury Department to issue regulations providing that the House bill does not apply in appropriate cases.

Effective date.–The House bill provision is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment provision, except the 30-day testing period is changed to a 31-day testing period.

In addition, the conferees intend that the Secretary will prescribe regulations to adapt the holding period and hedging rules of section 901(k) to property other than stock. It is anticipated that such regulations will provide that credits are not disallowed merely because a taxpayer eliminates its risk of loss from interest rate or currency fluctuations. In addition, it is intended that such regulations might permit other hedging activities, such as hedging of credit risk, provided that the taxpayer does not hedge most of its risk of loss with respect to the property unless there has been a meaningful and unanticipated change in circumstances.

15. Treatment of partnership loss transfers and partnership basis adjustments (sec. 633 of the House bill, sec. 469 of the Senate amendment, and secs. 704, 734, 743, and 754 of the Code)

Present Law

Contributions of property

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[530] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[531] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[532] Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[533] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.[534]

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.[535] If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time

[530] Sec. 721.

[531] Sec. 723.

[532] Sec. 722.

[533] Sec. 704(c)(1)(A).

[534] If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for curative or remedial allocations to remedy this insufficiency. Treas. Reg. sec. 1.704-3(c) and (d).

[535] Treas. Reg. sec. 1.704-3(a)(7).

election under section 754 to make basis adjustments.[536] If an election is in effect, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[537] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 is in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[538] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[539] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[540]

The determination of the basis of individual properties distributed by a partnership is dependent on the adjusted basis of the properties in the hands of the partnership.[541] If a partnership interest is transferred to a partner and the partnership has not elected to adjust the basis of partnership property, a special basis rule provides for the determination of the transferee partner's basis of properties that are later distributed by the partnership.[542] Under this rule, in determining the basis of property distributed by a partnership within 2 years following the transfer of the partnership interest, the transferee may elect to determine its basis as if the partnership had adjusted the basis of the distributed property under section 743(b) on the transfer. The special basis rule also applies to distributed property if, at the time of the transfer, the fair market value of partnership property other than money exceeds 110 percent of the partnership's basis in such property and a liquidation of the partnership interest immediately after

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[536] Sec. 743(a).

[537] Sec. 743(b).

[538] Sec. 731(a) and (b).

[539] Sec. 732(b).

[540] Sec. 732(a).

[541] Sec. 732 (a)(1) and (c).

[542] Sec. 732(d).

the transfer would have resulted in a shift of basis to property subject to an allowance of depreciation, depletion or amortization.[543]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[544] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[545] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

House Bill

Contributions of property

Under the provision, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[546]

Transfers of partnership interests

The provision provides generally that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

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[543] Treas. Reg. sec. 1.732-1(d)(4).

[544] Sec. 734(a).

[545] Sec. 734(b).

[546] It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the bill, section 743(b) applies, so that an adjustment is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

The bill provides that an electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. In lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. Under this rule, the transferee partner's distributive share of losses (determined without regard to gains) from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of such losses exceeds the loss recognized by the transferor partner. In the event of successive transfers, the transferee partner's distributive share of such losses is not allowed, except to the extent that it is established that such losses exceed the loss recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this rule). Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest. Thus, on subsequent disposition of its partnership interest, the partner's gain is reduced (or loss increased) because the basis of the partnership interest has not been reduced by such losses. The provision is applied without regard to any termination of a partnership under section 708(b)(1)(B). In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, the amount of the transferor's loss taken into account under this rule is reduced by the amount of the basis reduction.

For this purpose, an electing investment partnership means a partnership that satisfies the following requirements: (1) it makes an election under the provision that is irrevocable except with the consent of the Secretary; (2) it would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940[547] but for an exemption under paragraph (1) or (7) of section 3(c) of that Act; (3) it has never been engaged in a trade or business; (4) substantially all of its assets are held for investment; (5) at least 95 percent of the assets contributed to it consist of money; (6) no assets contributed to it had an adjusted basis in excess of fair market value at the time of contribution; (7) all partnership interests are issued by the partnership pursuant to a private offering and during the 24-month period beginning on the date of the first capital contribution to the partnership; (8) the partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and (9) the partnership agreement provides for a term that is not in excess of 15 years.

The provision requires an electing investment partnership to furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule.

[547] Section 3(a)(1)(A) of the Act provides, “when used in this title, 'investment company' means any issuer which is or hold itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”

Distributions of partnership property

The provision provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million, and that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C's hands is $5 million. Under present law, C would recognize a loss of $4 million if the LMN stock were sold for $1 million.

Under the provision, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than $250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by $2 million (the amount by which the basis of LMN stock was increased), leaving a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million.

Effective date

The provision applies to contributions, distributions and transfers (as the case may be) after the date of enactment.

In the case of an electing investment partnership in existence on June 4, 2004, the requirement that the partnership agreement have substantive restrictions on redemptions does not apply, and the requirement that the partnership agreement provide for a term not exceeding 15 years is modified to permit a term not exceeding 20 years.

Senate Amendment

Under the provision, adjustments to the basis of partnership property in the event of a partnership distribution or the transfer of a partnership interest are required, not elective as under present law. However, the basis adjustments are elective, as under present law, in the case of the transfer of a partnership interest by reason of the partner's death. Any election made by a partnership under section 754 that is in effect when the provision becomes effective is treated as an election to adjust the basis of partnership property with respect to the transferee partner in the case of a transfer of a partnership interest upon the death of a partner. The provision repeals the special rule of section 732(d) for determining the transferee partner's basis in property that is later distributed by the partnership in cases in which the partnership did not have a section 754 election in effect with respect to the transfer of the partnership interest.

Effective date.–The provision requiring partnership basis adjustments applies to transfers and distributions after the date of enactment.

The provision repealing section 732(d) applies generally to transfers after the date of enactment, except that it applies to distributions made after the date which is 2 years following the date of enactment in the case of any transfer to which section 732(d) applies that is made on or before the date of enactment.

Conference Agreement

The conference agreement generally follows the House bill, with modifications.

The conference agreement modifies the qualification requirements for electing investment partnerships that are subject to a partner-level loss limitation rule in lieu of the requirement of partnership basis adjustments following certain transfers of partnership interests. Specifically, the conference agreement requires that all partnership interests be issued by such a partnership pursuant to a private offering prior to the date that is 24 months after the date of the first capital contribution to the partnership. The conferees intend that "dry" closings in which partnership interests are issued without the contribution of capital not start the running of the 24-month period.

It is intended that in applying the requirement (with respect electing investment partnerships) that the partnership agreement have substantive restrictions on each partner's ability to cause a redemption, the following are illustrative examples of substantive restrictions: a violation of Federal or State law (such as ERISA or the Bank Holding Company Act); and imposition of a Federal excise tax on, or a change in the Federal tax-exempt status of, a tax-exempt partner.

The conferees understand that electing investment partnerships will generally include venture capital funds, buyout funds, and funds of funds. These funds are formed to raise capital from investors pursuant to a private offering and to make investments during the limited term of the partnership with the intention of holding the investments for capital appreciation.

With respect to the requirement that an electing investment partnership furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule, it is expected that in some cases the transferor of the partnership interest will furnish information relating to the amount of its loss to the transferee partner. It is intended that the requirement that the electing investment partnership furnish necessary information to the transferee partner be administered by the Treasury Secretary in a manner that (to the greatest extent feasible) minimizes the need for the partnership to furnish information to the transferee partner that the transferee partner has obtained from the transferor.

The conference agreement adds an exception for securitization partnerships to the rules requiring partnership basis adjustments in the case of transfers of partnership interests and distributions of property to a partner. The exceptions provide that a securitization partnership is not treated as having a substantial built-in loss in the case of a transfer of a partnership interest, or as having a substantial basis reduction in the case of a partnership distribution, and thus is not required to make basis adjustments to partnership property. Partnership basis adjustments remain elective for such a partnership. Unlike in the case of an electing investment partnership, the partner-level loss limitation rule does not apply in the case of a securitization partnership.

For this purpose, a securitization partnership is any partnership the sole business activity of which is to issue securities that provide for a fixed principal (or similar) amount and that are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of. It is intended that rules similar to those applicable to sponsors of REMICs apply in determining whether the sponsor's belief is reasonable.[548] It is not intended that the rules requiring partnership basis adjustments on transfers or distributions be avoided through dispositions of pool assets.

It is intended that an electing investment partnership or securitization partnership that subsequently fails to meet the definition of an electing investment partnership or of a securitization partnership will be subject to the partnership basis adjustment rules of the provision with respect to the first transfer of a partnership interest (and, in the case of a securitization partnership, the first distribution) that occurs after the partnership ceases to meet the applicable definition and to each subsequent transfer (and distribution, in the case of a securitization partnership).

It is not intended that the rules of the conference agreement provisions be avoided through the use of tiered partnerships.

It is not intended that the provision relating to contributions of built-in loss property limit the ability of master-feeder structures to apply an aggregate method for making allocations under section 704(c) to the extent the aggregate method is permitted under present law.[549]

<u>Effective date</u>.–The conference agreement follows the House bill.

[548] *See* Treas. Reg. sec. 1.860G-2(a)(3), providing that a sponsor's belief is not reasonable if the sponsor actually knows or has reason to know that the requirement is not met, or if the requirement is later discovered not to have been met.

[549] *See* Rev. Proc. 2001-36, 2001-1 C.B. 1326. Definitional requirements of a master-feeder structure include that there is a portfolio of assets that is treated as a partnership for Federal tax purposes and that is registered as an investment company under the Investment Company Act of 1940, each partner of which is a feeder fund that is a registered investment company (RIC) for Federal tax purposes, or is an investment advisor, principal underwriter, or manager of the portfolio. The conferees believe that these restrictions (and other applicable restrictions) serve to limit potential avoidance of the section 704(c) provision of the conference agreement through use of the aggregate method in the case of master-feeder structures.

16. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 634 of the House bill, sec. 432 of the Senate amendment, and sec. 755 of the Code)

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.[550] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[551] This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[552] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

Election to adjust basis of partnership property

When a partnership distributes partnership property, the basis of partnership property generally is not adjusted to reflect the effects of the distribution or transfer. However, the partnership is permitted to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[553] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner and (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the

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[550] Sec. 721(a).

[551] Sec. 731(a) and (b).

[552] Sec. 732(b).

[553] Sec. 754.

distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[554] In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[555]

House Bill

The provision provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the provision, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective date.–The provision applies to distributions after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except for the effective date.

Effective date.--The provision applies to distributions after February 13, 2003.

Conference Agreement

The conference agreement follows the House bill.

Effective date.–The conference agreement follows the House bill.

17. Repeal of special rules for FASITs (sec. 635 of the House bill, sec. 433 of the Senate amendment, and secs. 860H through 860L of the Code)

Present Law

Financial asset securitization investment trusts

In 1996 Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit

[554] Sec. 755(a).

[555] Sec. 755(b).

card receivables, home equity loans, and auto loans.[556] A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[557] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

[556] Sections 860H through 860L.

[557] Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

“Regular interests” of a FASIT

“Regular interests” of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest”, an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to REMIC interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate (“AFR”) for the calendar month in which the instrument is issued.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT’s owner (or a person related to the FASIT’s owner), the property is treated as being first acquired by the FASIT’s owner for the FASIT’s cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules.–In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT’s assets and liabilities are treated as assets and liabilities of the FASIT’s owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT’s owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount (“OID”) accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

House Bill

The House bill repeals the special rules for FASITs. The House bill provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the House bill also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the provision modifies the present-law definition of a REMIC "regular interest" to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the provision makes three modifications to the present-law definition of a "qualified mortgage." First, the provision modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the provision modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a "reverse mortgage loan" is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the provision modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the provision modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

Effective date.–Except as provided by the transition period for existing FASITs, the House bill is effective January 1, 2005.

Senate Amendment

The Senate amendment is the same as the House bill, except for the effective date.

Effective date.–Except as provided by the transition period for existing FASITs, the Senate amendment is effective on February 14, 2003.

Conference Agreement

The conference agreement follows the House bill provision.

18. Limitation on transfer and importation of built-in losses (sec. 636 of the House bill, sec. 431 of the Senate amendment, and secs. 362 and 334 of the Code)

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[558] The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[559]

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.[560]

House Bill

The House bill provides that if a residual interest (as defined in section 860G(a)(2)) in a real estate mortgage investment conduit ("REMIC") is contributed to a corporation and the transferee corporation's adjusted basis in the REMIC residual interest would (but for the provision) exceed the fair market value of the REMIC residual interest immediately after the contribution, the transferee corporation's adjusted basis in the REMIC residual interest is limited to the fair market value of the REMIC residual interest immediately after the contribution, regardless of whether the fair market value of the REMIC residual interest is less than, equal to, or greater than zero (i.e., the provision may result in the transferee corporation having a negative adjusted basis in the REMIC residual interest).

Effective date.–The House bill provision applies to transactions after the date of enactment.

Senate Amendment

Importation of built-in losses

The Senate Amendment provides that if a net built-in loss is imported into the U.S in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each

[558] Sec. 351.

[559] Sec. 358.

[560] Secs. 334(b) and 362(a) and (b).

property so transferred is its fair market value.[561] A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the Senate amendment, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceed the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U.S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if the properties had been transferred by each of the partners in proportion to their interests in the partnership.

Limitation on transfer of built-in losses in section 351 transactions

The Senate amendment provides that if the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property. Under the Senate Amendment, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. In the case of a transfer in which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation, any basis reduction required by the provision is made to the stock received by the transferor and not to the assets transferred.

Effective date

The Senate amendment provision applies to transactions after December 31, 2003.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications to the limitation on transfer of built-in losses in section 351 transactions. The conference agreement eliminates the provision that requires a basis reduction to be made to stock received by the transferor (rather than to the assets transferred) in the case of a transfer in which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation. Thus, the provision that limits the transferee's aggregate basis in the transferred property to the aggregate fair market value of the transferred property generally applies, regardless of the ownership percentage of the transferor in the stock of the transferee corporation.

In addition, the conference agreement permits the transferor and transferee to elect to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred. Such election shall be

[561] The Senate amendment also applies to transfers from a tax-exempt organization where gain or loss would not be subject to tax if the property were sold by the organization.

included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, shall be irrevocable.

19. Clarification of banking business for purposes of determining investment of earnings in U.S. property (sec. 637 of the House bill, sec. 451 of the Senate amendment, and sec. 956 of the Code)

Present Law

In general, the subpart F rules[562] require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property.[563]

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[564] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[565] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[566]

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

[562] Secs. 951-964.

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

[564] Sec. 956(a).

[565] Secs. 956 and 959.

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

secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[567]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[568]

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[569] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

House Bill

The House bill provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with persons at least 80 percent of the gross income of which is derived in the active conduct of a banking business from unrelated persons. For purposes of applying the House bill, the deposit recipient and all persons related to the deposit recipient are treated as one person in applying the 80-percent test.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law.

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

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

[569] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

Effective date.–The House bill provision is effective on the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment applies the 80-percent test by reference to financial services income (as defined in section 904(d)(2)(C)(ii) rather than the active conduct of a banking business.

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with: (1) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c), without regard to paragraphs (C) and (G) of paragraph (2) of such section); or (2) any other corporation with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law.

Effective date.–The conference agreement provision is effective on the date of enactment.

20. Alternative tax for small insurance companies and modification of exemption from tax for small property and casualty insurance companies (sec. 638 of the House bill, sec. 493 of the Senate amendment, and secs. 501(c)(15) and 831(b) of the Code)

Present Law

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (sec. 831(b)). For purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account (including foreign and tax-exempt corporations).

A property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts.[570] For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account (including gross receipts of foreign and tax-exempt corporations).

House Bill

Under the provision, the $1.2 million ceiling on net written premiums or direct written premiums for purposes of the election to be taxed only on taxable investment income is increased to $1.89 million, and is indexed for taxable years beginning in a calendar year after 2004.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment follows the House bill, except that the $1.89 million amount is indexed for taxable years beginning in a calendar year after 2005. In addition, the Senate amendment modifies one of the present-law requirements for a property and casualty insurance company to eligible to be exempt from Federal income tax by requiring that the premiums received for the taxable year be greater than 60 percent of its gross receipts (rather than 50 percent as under present law).

Effective date.–The provision is effective for taxable years beginning after December 31, 2004.[571]

Conference Agreement

The conference agreement does not include the House bill provision or the Senate amendment provision.

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[570] A special rule provides that a mutual property and casualty insurance company is eligible to be exempt from Federal income tax under the provision if (a) its gross receipts for the taxable year do not exceed $150,000, and (b) the premiums received for the taxable year are greater than 35 percent of its gross receipts, provided certain requirements are met. The requirements are that no employee of the company or member of the employee's family is an employee of another company that is exempt from tax under section 501(c)(15) (or would be, but for this rule).

[571] The provision preserves the transition rule that was provided under section 206(e) of the Pension Funding Equity Act of 2004 (Pub. L. No. 108-218) relating to companies in receivership or liquidation.

21. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions (sec. 639 of the House bill, sec. 417 of the Senate amendment, and sec. 163 of the Code)

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[572] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

House Bill

The House bill disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed listed transaction or from an undisclosed reportable avoidance transaction (other than a listed transaction).[573]

Effective date.–The House bill provision is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment also disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from a transaction that lacks economic substance.

Effective date.–The Senate amendment provision is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the House bill.

22. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 640 of the House bill, sec. 481 of the Senate amendment, and sec. 338 of the Code)

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a

[572] Sec. 163(a).

[573] The definitions of these transactions are the same as those previously described in connection with the provision elsewhere in this bill to modify the accuracy-related penalty for listed and certain reportable transactions.

corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

House Bill

The bill clarifies section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the bill if a transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed based on an asset sale, computed from the date of the sale.

If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

Effective date.–The bill is effective for qualified stock purchase transactions that occur after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The Conference agreement follows the House bill and the Senate amendment.

23. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 641 of the House bill and sec. 492 of the Senate amendment)

Present Law

A taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

House Bill

The House bill provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

Effective date.–Sales or exchanges of principal residences after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

24. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 642 of the House bill, sec. 453 of the Senate amendment, and secs. 163 and 267 of the Code)

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (secs. 951-964), the passive foreign investment company rules (secs. 1291-1298), and the foreign personal holding company rules (secs. 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[574] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[575] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[576]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[577] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[578] As in the case of OID, the Treasury regulations additionally provide that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[579]

House Bill

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion

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[574] Sec. 163(e)(1).

[575] Sec. 163(e)(3).

[576] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue have in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[577] Sec. 267(a)(2).

[578] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[579] Treas. Reg. sec. 1.267(a)-3(c)(4).

rules.[580] Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid.

For purposes of determining the amount of the deduction allowable, the extent that an amount attributable to OID or an item is includible in the income of a U.S. person is determined without regard to (1) properly allocable deductions of the related foreign corporation, and (2) qualified deficits of the related foreign corporation under section 952(c)(1)(B). Properly allocable deductions of the related foreign corporation are those expenses, losses, and other deductible amounts of the related foreign corporation that are properly allocated or apportioned, under the principles of section 954(b)(5), to the relevant income item of the related foreign corporation.

The provision grants the Secretary regulatory authority to exempt transactions from these rules, including any transactions entered into by the payor in the ordinary course of a trade or business in which the payor is predominantly engaged, and (in the case of items other than OID) in which the payment of the accrued amounts occurs shortly after its accrual.

Effective date.–The provision is effective for payments accrued on or after date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

The following examples illustrate the operation of this provision. Assume the following facts. A U.S. parent corporation owns 60 percent of the stock of a CFC. An unrelated foreign corporation owns the remaining 40 percent interest in the CFC. The U.S. parent accrues an expense item of 100 to the CFC. The parent would be entitled to a current deduction of 100 for the accrued amount, before taking into account this provision. The item constitutes gross foreign base company income in the hands of the CFC. The item is the only gross income item of the CFC that has the potential to result in the CFC having subpart F income, and has not been paid by the end of the taxable year of the parent. The CFC has deductions of 60 that are properly allocated or apportioned to the 100 of gross foreign base company income under the principles of section 954(b)(5), resulting in 40 (100 – 60) of net foreign base company income. The CFC has earnings and profits for its taxable year in excess of 40, and has 40 of subpart F income. Under these facts, the U.S. parent is allowed a current deduction of 60 (100 × 60%) under the provision.

[580] Section 413 of the conference agreement repeals the foreign personal holding company regime, effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

If, in the example above, the CFC has deductions of 100 (or more) properly allocated or apportioned to the sole item of 100 of gross foreign base company income under the principles of section 954(b)(5), and has no other income or deductions, the same deduction is allowed to the U.S. parent. Under these circumstances, the parent is allowed a deduction of 60, whether the CFC has positive earnings and profits for its taxable year or has a deficit in earnings and profits for such year.

If the CFC's item of net foreign base company income is positive, and the earnings and profits limitation of section 952(c)(1)(A) reduces what would otherwise be a U.S. shareholder's pro rata share of the CFC's subpart F income, then the deduction will also be reduced under the provision. For example, assume the facts in the first example above, in which the CFC has deductions of 60 that are properly allocated or apportioned to the item of 100 of gross foreign base company income under the principles of section 954(b)(5), resulting in 40 of net foreign base company income. Further assume that, due solely to other losses, the CFC's earnings and profits for its taxable year are 10 instead of 40. In that case, the CFC's subpart F income is limited to 10, and only six is includible in the gross income of the U.S. parent as its pro rata share of subpart F income. Under the provision, the U.S. parent is allowed a current deduction in that case of 42 ((10 + 60) × 60%). The conferees intend that, if as a result of such other losses, the CFC has no earnings and profits for its taxable year or has a deficit in earnings and profits for such year, the U.S. parent is instead allowed a current deduction of 36 ((0 + 60) × 60%).

25. Exclusion from gross income for interest on overpayments of income tax by individuals (sec. 643 of the House bill)

Present Law

Overpayment interest

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy. Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.

Underpayment interest

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business." The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Eighth, and Ninth Circuits.

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.

House Bill

The bill excludes overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision is not considered disqualified income that could limit the earned income credit. Interest excluded under the provision also is not considered in determining what portion of a taxpayer's social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest does not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

It is expected that the Secretary will indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for taxable year in which the underpayment interest is paid.

Effective date.–Interest received in calendar years beginning after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

26. Deposits made to suspend the running of interest on potential underpayments (sec. 644 of the House bill, sec. 486 of the Senate amendment, and new sec. 6603 of the Code))

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

House Bill

In general

The provision allows a taxpayer to deposit cash with the IRS that may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is deposited for the period that the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Withdrawal of amounts

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April

15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer (1) has a reasonable basis for the treatment used on its return and (2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

Effective date.–Deposits made after date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

27. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 645 of the House bill, sec. 484 of the Senate amendment, and sec. 6159 of the Code)

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

House Bill

The provision clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The provision also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Effective date.–Installment agreements entered into on or after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

28. Affirmation of consolidated return regulation authority (sec. 646 of the House bill, sec. 421 of the Senate amendment, and sec. 1502 of the Code)

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[581]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be

[581] Sec. 1501.

returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[582]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[583]

In the recent case of *Rite Aid Corp. v. United States,*[584] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[585] The particular

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[582] Sec. 1502.

[583] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15 (1928), describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v. United States,* 1 Ct. Cl. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied,* 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner,* 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

[584] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[585] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra*. *See also Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner,* 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner,* 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation*, 31 B.T.A.

provision, known as the "duplicated loss" provision,[586] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[587]

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[588]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and

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978 (1935); *Helvering v. Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term "taxable year."

[586] Treas. Reg. sec. 1.1502-20(c)(1)(iii).

[587] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[588] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[589] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [590]

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the

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[589] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[590] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[591]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[592]

House Bill

The provision confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that the Secretary is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision. The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, provided that such regulations are necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation.

The provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the bill provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition

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[591] *Rite Aid*, 255 F.3d at 1360.

[592] *See* Temp. Reg. Sec. 1.1502-20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See, e.g.* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); T.D. 9048, 68 F.R. 12287 (March 14, 2003); and T.D. 9118, REG-153172-03 (March 17, 2004).

of stock of a consolidated subsidiary[593] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[594]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[595]

Effective date.–The provision is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is intended that the results following from this provision are not the same as the results under present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The Conference agreement follows the House bill and the Senate Amendment.

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[593] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[594] The provision is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

[595] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)); and T.D. 9118, REG-153172-03 (March 17, 2004). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

29. Reform of tax treatment of certain leasing arrangements and limitation on deductions allocable to property used by governments or other tax-exempt entities (secs. 647 through 649 of the bill, secs. 475 and 476 of the Senate amendment, secs. 167 and 168 of the Code, and new sec. 470 of the Code)

Present Law

Overview of depreciation

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods based on such property's class life. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years and are significantly shorter than the property's class life, which is intended to approximate the economic useful life of the property. In addition, the depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Characterization of leases for tax purposes

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[596]

Recovery period for tax-exempt use property

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[597] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term lease) to a tax-exempt entity.[598] For this purpose, the term "tax-

[596] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[597] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

[598] Sec. 168(h)(1).

exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[599]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[600] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[601]

Also, tax-exempt use property generally does not include qualified technological equipment that meets the exception for leases of high technology equipment to tax-exempt entities with lease terms of five years or less.[602] The recovery period for qualified technological equipment that is treated as tax-exempt use property, but is not subject to the high technology equipment exception, is five years.[603]

The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[604] In addition, tax-exempt use property does not include computer software because it is intangible property.

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[599] Sec. 168(h)(2).

[600] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[601] Sec. 168(h)(1)(C).

[602] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[603] Sec. 168(g)(3)(C).

[604] Sec. 168(i)(2).

House Bill

Overview

The House bill modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, expands the short-term lease exception for qualified technological equipment, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

Modify the recovery period of certain property leased to a tax-exempt entity

The House bill modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity[605] to be the longer of the property's assigned class life (or assigned useful life in the case of computer software) or 125 percent of the lease term. The House bill does not apply to short-term leases, as defined under present law with a modification described below for short-term leases of qualified technological equipment.

Modify definition of lease term

In determining the length of the lease term for purposes of the 125-percent calculation, the House bill provides that the lease term includes all service contracts (whether or not treated as a lease under section 7701(e)) and other similar arrangements that follow a lease of property to a tax-exempt entity and that are part of the same transaction (or series of transactions) as the lease.[606]

Under the House bill, service contracts and other similar arrangements include arrangements by which services are provided using the property in exchange for fees that provide a source of repayment of the capital investment in the property.[607]

This requirement applies to all leases of property to a tax-exempt entity.

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[605] The House bill defines a tax-exempt entity as under present law. Thus, it includes Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

[606] A service contract involving property that previously was leased to the tax-exempt entity is not part of the same transaction as the preceding leasing arrangement (and, thus, is not included in the lease term of such arrangement) if the service contract was not included in the terms and conditions, or contemplated at the inception, of the preceding leasing arrangement.

[607] For purposes of the House bill, a service contract does not include an arrangement for the provision of services if the leased property or substantially similar property is not utilized to provide such services. For example, if at the conclusion of a lease term, a tax-exempt lessee purchases property from the taxpayer and enters into an agreement pursuant to which the taxpayer maintains the property, the maintenance agreement will not be included in the lease term for purposes of the 125-percent computation.

Expand short-term lease exception for qualified technological equipment

For purposes of determining whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present-law 5-year short-term lease exception for leases of qualified technological equipment, the House bill provides that the term of the lease does not include an option or options of the lessee to renew or extend the lease, provided the rents under the renewal or extension are based upon fair market value determined at the time of the renewal or extension. The aggregate period of such renewals or extensions not included in the lease term under this provision may not exceed 24 months. In addition, this provision does not apply to any period following the failure of a tax-exempt lessee to exercise a purchase option if the result of such failure is that the lease renews automatically at fair market value rents.

Limit deductions for certain leases of property to tax-exempt parties

The House bill also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions for a taxable year from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This provision does not apply to certain transactions involving property with respect to which the low-income housing credit or the rehabilitation credit is allowable.

This provision applies to deductions or losses related to a lease to a tax-exempt entity and the leased property.[608] Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year subject to the same limitations. Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all of the gain or loss from the disposition is recognized),[609] a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations of this provision if the lease satisfies all of the following requirements:[610]

(1) Tax-exempt lessee does not monetize its lease obligations

[608] Deductions related to a lease of tax-exempt use property include any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.

[609] *See* Sec. 469(g).

[610] Even if a transaction satisfies each of the following requirements, the taxpayer will be treated as the owner of the leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property under the present-law tax rules, including the benefits and burdens of ownership.

In general, the tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis[611] in the leased property at the time the lease is entered into.[612] Specifically, a lease does not satisfy this requirement if the tax-exempt lessee monetizes such excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or options under the lease. This determination shall be made at all times during the lease term and shall include the amount of any interest or other income or gain earned on any amount set aside or subject to an arrangement described in this provision. For purposes of determining whether amounts have been set aside or are expected to be set aside, amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that such amounts are set aside or expected to be set aside.[613]

The Secretary may provide by regulations that this requirement is satisfied, even if a tax-exempt lessee monetizes its lease obligations or options in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property, in cases in which the creditworthiness of the tax-exempt lessee would not otherwise satisfy the taxpayer's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's adjusted basis in the property. In addition, if the lease provides the tax-exempt lessee an option to purchase the property for a fixed purchase price (or for other than the fair market value of the property determined at the time of exercise of the option), such credit support at the time that such option may be exercised would not be permitted to exceed 50 percent of the purchase option price.

Certain lease arrangements that involve circular cash flows or insulation of the taxpayer's equity investment from the risk of loss fail this requirement without regard to the amount in which the tax-exempt lessee monetizes its lease obligations or options. Thus, a lease does not satisfy this requirement if the tax-exempt lessee enters into an arrangement to monetize in any amount its lease obligations or options if such arrangement involves (1) a loan (other than an

[611] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[612] Arrangements to monetize lease obligations include defeasance arrangements, loans by the tax-exempt entity (or an affiliate) to the taxpayer (or an affiliate) or any lender, deposit agreements, letters of credit collateralized with cash or cash equivalents, payment undertaking agreements, prepaid rent (within the meaning of the regulations under section 467), sinking fund arrangements, guaranteed investment contracts, financial guaranty insurance, or any similar arrangements.

[613] It is anticipated under the House bill that the customary and budgeted funding by tax-exempt entities of current obligations under a lease through unrestricted accounts or funds for general working capital needs will not be considered arrangements, set-asides, or expected set-asides under this requirement.

amount treated as a loan under section 467 with respect to a section 467 rental agreement) from the tax-exempt lessee to the taxpayer or a lender, (2) a deposit that is received, a letter of credit that is issued, or a payment undertaking agreement that is entered into by a lender otherwise involved in the transaction, or (3) in the case of a transaction that involves a lender, any credit support made available to the taxpayer in which any such lender does not have a claim that is senior to the taxpayer.

(2) Taxpayer makes and maintains a substantial equity investment in the leased property

The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis[614] in the leased property at that time,[615] (2) the taxpayer maintains such equity investment throughout the lease term, and (3) at all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis.[616] For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property.

This requirement does not apply to leases with lease terms of 5 years or less.

(3) Tax-exempt lessee does not bear more than a minimal risk of loss

The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease.[617] For this purpose, a tax-exempt lessee

[614] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[615] The taxpayer's at-risk equity investment shall include only consideration paid, and personal liability incurred, by the taxpayer to acquire the property. *Cf.* Rev. Proc. 2001-28, 2001-2 C.B. 1156.

[616] *Cf.* Rev. Proc. 2001-28, sec. 4.01(2), 2001-1 C.B. 1156. The fair market value of the property must be determined without regard to inflation or deflation during the lease term and after subtracting the cost of removing the property.

[617] Examples of arrangements by which a tax-exempt lessee might assume or retain a risk of loss include put options, residual value guarantees, residual value insurance, and service contracts. However, leases do not fail to satisfy this requirement solely by reason of lease provisions that require the tax-exempt lessee to pay a contractually stipulated loss value to the taxpayer in the event of an early termination due to a casualty loss, a material default by the tax-

assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination.[618] In addition, the Secretary may provide by regulations that this requirement is not satisfied where the tax-exempt lessee otherwise retains or assumes more than a minimal risk of loss. Such regulations shall be prospective only.

This requirement does not apply to leases with lease terms of 5 years or less.

Coordination with like-kind exchange and involuntary conversion rules

Under this provision, neither the like-kind exchange rules (sec. 1031) nor the involuntary conversion rules (sec. 1033) apply if either (1) the exchanged or converted property is tax-exempt use property subject to a lease that was entered into prior to the effective date of this provision and the lease would not have satisfied the requirements of this provision had such requirements been in effect when the lease was entered into, or (2) the replacement property is tax-exempt use property subject to a lease that does not meet the requirements of this provision.

Other rules

This provision continues to apply throughout the lease term to property that initially was tax-exempt use property, even if the property ceases to be tax-exempt use property during the lease term.[619] In addition, this provision is applied before the application of the passive activity loss rules under section 469.

This provision does not alter the treatment of any Qualified Motor Vehicle Operating Agreement within the meaning of section 7701(h). In the case of any such agreement, the second and third requirements provided by this provision (relating to taxpayer equity investment and tax-exempt lessee risk of loss, respectively) shall be applied without regard to any terminal rental adjustment clause.

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exempt lessee (excluding the failure by the tax-exempt lessee to enter into an arrangement described above), or other similar extraordinary events that are not reasonably expected to occur at lease inception.

[618] For purposes of this requirement, residual value protection provided to the taxpayer by a manufacturer or dealer of the leased property is not treated as borne by the tax-exempt lessee if the manufacturer or dealer provides such residual value protection to customers in the ordinary course of its business.

[619] Conversely, however, a lease of property that is not tax-exempt use property does not become subject to this provision solely by reason of requisition or seizure by the Federal government in national emergency circumstances.

Effective date

The House bill provision generally is effective for leases entered into after March 12, 2004.[620] However, the House bill provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2005, and (3) includes a description and the fair market value of such property.

The House bill provisions relating to coordination with the like-kind exchange and involuntary conversion rules are effective with respect to property that is exchanged or converted after the date of enactment.

No inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date of the House bill provision. In addition, it is intended that the House bill provision shall not be construed as altering or supplanting the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property, including the benefits and burdens of ownership. The House bill provision also is not intended to affect the scope of any other present-law tax rules or doctrines applicable to purported leasing transactions.

Senate Amendment

Overview

The Senate amendment is similar to the House bill in that it modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

Modify the recovery period of certain property leased to a tax-exempt entity

The Senate amendment provision that modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity is the same as the House bill provision.

Modify definition of lease term

The Senate amendment provision that modifies the definition of a lease term is the same as the House bill provision.

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[620] If a lease entered into on or before March 12, 2004, is transferred in a transaction that does not materially alter the terms of such lease, the bill shall not apply to the lease as a result of such transfer.

Expand short-term lease exception for qualified technological equipment

The Senate amendment does not include the House bill provision that excludes certain renewals and extensions of up to 24 months from the determination of whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present-law 5-year short-term lease exception for leases of qualified technological equipment.

Limit deductions for certain leases of property to tax-exempt parties

The Senate amendment is similar to the House bill in that it limits a taxpayer's deductions for a taxable year from a lease transaction with a tax-exempt entity to the taxpayer's gross income from the lease for that taxable year. However, the Senate amendment does not exclude transactions involving property with respect to which the rehabilitation credit is allowable.

Like the House bill, the Senate amendment provides that a lease of property to a tax-exempt party is not subject to the deduction limitations of this provision if the lease satisfies a series of requirements similar to that provided in the House bill, with the following modifications:

(1) Leased property is not financed with tax-exempt bonds or Federal funds

The Senate amendment provides that the leased property must not have been not directly or indirectly financed with tax-exempt bonds that are outstanding when the lease is entered into, or with Federal funds. This requirement is not included in the House bill.

For example, a lease of rolling stock to a municipality would be subject to the Senate amendment if the proceeds of the municipality's general obligation bond were used to finance the acquisition of the rolling stock (in whole or part) and the bond is outstanding when the lease is entered into.

The Senate amendment permits the Secretary to provide a de minimis exception from this requirement.

(2) Tax-exempt lessee does not monetize its lease obligations

The Senate amendment is similar to the House bill in that it provides that the tax-exempt lessee may not monetize its lease obligations in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property at the time the lease is entered into. However, the Senate amendment also permits the Secretary to identify arrangements (in addition to those specified in the provision) to which the requirement applies.

(3) Taxpayer makes and maintains a substantial equity investment in the leased property

The Senate amendment is similar to the House bill in that it requires the taxpayer to make and maintain a substantial equity investment in the leased property. However, the Senate amendment does not generally exclude from the application of this requirement leases with lease terms of 5 years or less. Instead, the Senate amendment provides that, with respect to short-term leases as defined under present law, the taxpayer is required to make a substantial equity investment, but is not required to maintain a substantial equity investment, and the leased property is not required to be reasonably expected to equal 20 percent of the taxpayer's adjusted basis at the time the lease is entered into.

(4) Tax-exempt lessee does not bear more than a minimal risk of loss

The Senate amendment is similar to the House bill in that it provides that the tax-exempt lessee generally may not assume or retain more than a minimal risk of loss with respect to the lease. However, the Senate amendment does not exclude from the application of this requirement leases with lease terms of 5 years or less.

(5) Lease of certain property does not include a fixed-price purchase option of the tax-exempt lessee

The Senate amendment provides that the tax-exempt lessee may not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property (as determined at the time of exercise of the option). This requirement does not apply to property with a class life (as defined in section 168(i)(1)) of seven years or less. This requirement is not included in the House bill.

(6) Lease meets any other requirement prescribed in regulations

The Senate amendment requires the lease to meet any other requirements that the Secretary prescribes by regulations. This requirement is not included in the House bill.

Coordination with like-kind exchange and involuntary conversion rules

The Senate amendment does not include the House bill provisions that coordinate the like-kind exchange and involuntary conversion rules with the deduction limitation provision.

Effective date

The Senate amendment provision generally is effective for leases entered into after November 18, 2003. However, with respect to tax-exempt use property that is leased to a foreign tax-exempt entity or person in a transaction entered into on or before November 18, 2003, the Senate amendment provision is effective for taxable years beginning after January 31, 2004.

Conference Agreement

The conference agreement follows the House bill, with the following modifications.

Definition of tax-exempt entity

The conference agreement expands the present-law definition of tax-exempt entity for this purpose to include certain Indian tribal governments in addition to Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

Modify the recovery period of certain property leased to a tax-exempt entity

The conference agreement also modifies the recovery period for certain intangibles leased to a tax-exempt entity to be the no less than 125 percent of the lease term.[621] The conference agreement modification does not apply to short-term leases, as defined under present law with a modification described below for short-term leases of qualified technological equipment.

Limit deductions for leases of property to tax-exempt parties

The conference agreement provides an additional requirement that must be satisfied to avoid the deduction limitations for certain leases of property to tax-exempt parties. This requirement provides that the tax-exempt lessee may not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property (as determined at the time of exercise of the option). This requirement does not apply to (1) property with a class life (as defined in section 168(i)(1)) of seven years or less, or (2) any fixed-wing aircraft or vessels (i.e., ships).

Effective date

The conference agreement modifies the Federal Transit Administration approval deadline to January 1, 2006.

In addition, the conference agreement provides that the provisions relating to intangible assets and Indian tribal governments are effective for leases entered into after October 3, 2004.

30. Clarification of the economic substance doctrine (sec. 401 of the Senate amendment and sec. 7701 of the Code)

Present Law

In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan

[621] In the case of computer software and intangible assets, this rule is applied by substituting useful life and amortization period, respectively, for class life.

their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[622]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[623]

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[624]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with

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[622] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[623] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine". *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

[624] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[625]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[626] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of *both* economic substance (i.e., the objective component) *and* business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[627] A narrower approach used by some courts is to conclude that either a business purpose *or* economic substance is sufficient to respect the transaction).[628] A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[629]

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[625] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[626] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

[627] *See, e.g.*, *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.")

[628] *See, e.g.*, *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test).") As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

[629] *See, e.g.*, *ACM Partnership v. Commissioner,* 157 F.3d at 247; *James v. Commissioner,* 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner,* 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory v. Helvering*,[630] several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[631] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[632] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[633] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies and enhances the application of the economic substance doctrine. The Senate amendment provides that, in a case in which a court determines that the

more precise factors to consider . . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[630] 293 U.S. 465 (1935).

[631] *See, e.g.*, *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

[632] *See, e.g.*, *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[633] *See, e.g.*, *Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, *citing Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[634]

The Senate amendment does not change current law standards used by courts in determining when to utilize an economic substance analysis.[635] Also, the Senate amendment does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.[636] The Senate amendment provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

The Senate amendment clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the Senate amendment, a transaction must satisfy *both* tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-tax business purpose

The Senate amendment provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must

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[634] If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.

[635] *See, e.g.*, Treas. Reg. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

[636] *See, e.g., Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[637]

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[638] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[639] should not

[637] *See, e.g.*, Treas. reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

[638] However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

[639] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[640]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the Senate amendment reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[641]

Profit potential

Under the Senate amendment, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the Senate amendment merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[642] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

Transactions with tax-indifferent parties

The Senate amendment also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected

[640] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

[641] *See, e.g., ACM Partnership v. Commissioner,* 157 F.3d at 256 n.48.

[642] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of the Senate amendment, and (2) other rules as may be necessary or appropriate to carry out the purposes of the Senate amendment.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the Senate amendment shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and the Senate amendment shall be construed as being additive to any such other doctrine.

Effective date

The Senate amendment provision applies to transactions entered into after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

31. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 404 of the Senate amendment and sec. 6662B of the Code)

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[643] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

[643] Sec. 6662.

Special rules apply with respect to tax shelters.[644] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[645] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[646]

House Bill

No provision.

Senate Amendment

The Senate amendment imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[647] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the Senate amendment (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier Senate amendment provision regarding the economic substance doctrine),[648] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier Senate amendment provision

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[644] Sec. 6662(d)(2)(C).

[645] Sec. 6664(c).

[646] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[647] Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this provision applies to any transaction that lacks economic substance.

[648] The provision provides that a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

regarding the economic substance doctrine),[649] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the Senate amendment, the calculation of an "understatement" is made in the same manner as in the separate Senate amendment provision relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under the Senate amendment provision would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[650] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

A public entity that is required to pay a penalty under the Senate amendment (regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Prior to this penalty being asserted in the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals (e.g., a Revenue Agent Report), the IRS Chief Counsel or his delegate at the IRS National Office must approve the inclusion in writing. Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to

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[649] The provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

[650] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

Congress summarizing the application of this penalty and providing a description of each penalty compromised under the Senate amendment and the reasons for the compromise.

Any understatement to which a penalty is imposed under the Senate amendment will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under the Senate amendment would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under the Senate amendment will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective date. –The Senate amendment provision applies to transactions entered into after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

32. Understatement of taxpayer's liability by income tax return preparer (sec. 411 of the Senate amendment)

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits, or a frivolous position, is liable for a penalty of $250, provided the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

House Bill

No provision.

Senate Amendment

The Senate amendment alters the standards of conduct that must be met to avoid imposition of the first penalty by replacing the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The Senate amendment also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position, increases the present-law $250 penalty to $1,000, and increases the present-law $1,000 penalty to $5,000.

Effective date.–Documents prepared after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

33. Frivolous tax submissions (sec. 413 of the Senate amendment and sec. 6702 of the Code)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[651] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

House Bill

No provision.

Senate Amendment

The provision modifies the IRS-imposed penalty by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The provision also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision permits the IRS to dismiss such requests. Second, the provision permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The provision requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

Effective date.–Submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[651] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

34. Authorization of appropriations for tax law enforcement (sec. 418 of the Senate amendment)

Present Law

There is no explicit authorization of appropriations to the IRS to be used to combat abusive tax avoidance transactions.

House Bill

No provision.

Senate Amendment

The provision includes an authorization of an additional $300 million to the IRS to be used to combat abusive tax avoidance transactions.

Effective date.–Date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

35. Declaration by chief executive officer relating to Federal annual corporate income tax return (sec. 422 of the Senate amendment)

Present Law

The Code requires[652] that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

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[652] Sec. 6062.

The Code also imposes[653] a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than $100,000[654] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

House Bill

No provision.

Senate Amendment

The provision requires that a corporation's Federal income tax return include a declaration signed under penalties of perjury by the chief executive officer of the corporation that the corporation has in place processes and procedures to ensure that the return complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. This declaration is part of the income tax return. The provision is in addition to the requirement of present law as to the signing of the income tax return itself. Because a CEO's duties generally do not require a detailed or technical understanding of the corporation's tax return, it is anticipated that this declaration of the CEO will be more limited in scope than the declaration of the officer required to sign the return itself.

The Secretary of the Treasury shall prescribe the matters to which the declaration of the CEO applies. It is intended that the declaration help insure that the preparation and completion of the corporation's tax return be given an appropriate level of care. For example, it is anticipated that the CEO would declare that processes and procedures have been implemented to ensure that the return complies with the Internal Revenue Code and all regulations and rules promulgated thereunder. Although appropriate processes and procedures can vary for each taxpayer depending on the size and nature of the taxpayer's business, in every case the CEO should be briefed on all material aspects of the corporation's tax return by the corporation's chief financial officer (or another person authorized to sign the return under present law).

If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the declaration. It is intended that the IRS issue general guidance, such as a revenue procedure, to: (1) address situations when a corporation does not have a chief executive officer; and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title, when a corporation has multiple chief executive officers, or when the corporation is a

[653] Sec. 7206.

[654] Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is $250,000.

foreign corporation and the CEO is not a U.S. resident.[655] It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign this declaration.

The provision does not apply to the income tax returns of mutual funds;[656] they are required to be signed as under present law.

Effective date.–Federal tax returns for taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

36. Denial of deduction for certain fines, penalties, and other amounts (sec. 423 of the Senate amendment and sec. 162 of the Code)

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[657]

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

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[655] With respect to foreign corporations, it is intended that the rules for signing this declaration generally parallel the present-law rules for signing the return. See Treas. Reg. sec. 1.6062-1(a)(3).

[656] The provision does, however, apply to the income tax returns of mutual fund management companies and advisors.

[657] S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

House Bill

No provision.

Senate Amendment

The bill modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the bill generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law [658] are nondeductible under any provision of the income tax provisions.[659] The bill applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.[660]

The bill is intended to apply only where a government (or other entity treated in a manner similar to a government under the bill) is a complainant or investigator with respect to the violation or potential violation of any law.[661]

It is intended that a payment will be treated as restitution only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.[662] Restitution is limited to the amount that bears a substantial quantitative

[658] The bill does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the bill would affect that payment.

[659] The bill provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[660] The bill does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

[661] Thus, for example, the bill would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgement or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the provision.

[662] Similarly, a payment to a charitable organization benefitting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative

relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are restitution likewise applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the Senate amendment is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective date.-- The bill is effective for amounts paid or incurred on or after April 28, 2003; however the proposal does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained on or before April 27, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

37. Denial of deduction for punitive damages (sec. 424 of the Senate amendment and sec. 162 of the Code)

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[663] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[664] In

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relationship to the harm caused, would not qualify as restitution. Under the provision, such a payment not deductible under section 162 would also not be deductible under section 170.

[663] Sec. 162(a).

[664] Sec. 162(c).

addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[665] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[666]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[667] However, this exclusion does not apply to punitive damages.[668]

House Bill

No provision.

Senate Amendment

The Senate amendment denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective date.–The Senate amendment provision is effective for punitive damages that are paid or incurred on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

38. Increase in criminal monetary penalty limitation for the underpayment or overpayment of tax due to fraud (sec. 425 of the Senate amendment)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

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[665] Sec. 162(f).

[666] Sec. 162(g).

[667] Sec. 104(a).

[668] Sec. 104(a)(2).

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[669] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

House Bill

No provision.

Senate Amendment

Attempt to evade or defeat tax

The bill increases the criminal penalty under section 7201 of the Code for individuals to $250,000 and for corporations to $1,000,000. The bill increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The bill increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

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[669] Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

Fraud and false statements

The bill increases the criminal penalty under section 7206 of the Code for individuals to $250,000 and for corporations to $1,000,000. Increases the maximum prison sentence to five years. The bill provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective date

Underpayments and overpayments attributable to actions occurring after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

39. Expanded disallowance of deduction for interest on convertible debt (sec. 434 of the Senate amendment and sec. 163 of the Code)

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income as it accrues.

Under present law, no deduction is allowed for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into equity of the issuer or a related party.[670] In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of equity of the issuer or related party.[671] A debt instrument also is treated

[670] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

[671] Sec. 163(l)(3)(B).

as payable in equity if it is part of an arrangement that is designed to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that option will be exercised.[672]

House Bill

No provision.

Senate Amendment

The Senate amendment expands the present-law disallowance of interest deductions on certain convertible or equity-linked corporate debt that is payable in, or by reference to the value of, equity. Under the Senate amendment, the disallowance is expanded to include interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or by any related party) in any other person, without regard to whether such equity represents more than a 50-percent ownership interest in such person. However, the Senate amendment does not apply to debt that is issued by an active dealer in securities (or by a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

Effective date.–The Senate amendment provision applies to debt instruments that are issued after February 13, 2003.

Conference Agreement

The conference agreement follows the Senate amendment, except the conference agreement applies to debt instruments that are issued after October 3, 2004.

40. Expand authority to disallow tax benefits under section 269 (sec. 435 of the Senate amendment and sec. 269 of the Code)

Present Law

Section 269 provides that if a taxpayer acquires, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary may disallow the tax benefits.[673] Similarly, if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately before the acquisition), the basis of such property is determined by reference to the

[672] Sec. 163(l)(3)(C).

[673] Sec. 269(a)(1).

basis in the hands of the transferor corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing a tax benefit that would not otherwise have been available, the Secretary may disallow such tax benefits.[674]

House Bill

No provision.

Senate Amendment

The Senate amendment expands section 269 by repealing the requirement that the acquisition of property be from a corporation not controlled by the acquirer. Thus, under the Senate amendment, section 269 disallows the tax benefits of (1) any acquisition of stock sufficient to obtain control of a corporation (as under present law), and (2) any acquisition by a corporation of property from a corporation in which the basis of such property is determined by reference to the basis in the hands of the transferor corporation, if the principal purpose of such acquisition is the evasion or avoidance of Federal income tax.

Effective date.--The Senate amendment applies to stock and property acquired after February 13, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

41. Modification of coordination rules for controlled foreign corporation and passive foreign investment company regimes (sec. 436 of the Senate amendment and sec. 1297 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[675] and the passive foreign investment company rules.[676] Deferral of U.S. tax is considered appropriate, on the other hand, with respect

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[674] Sec. 269(a)(2).

[675] Secs. 951-964.

[676] Secs. 1291-1298.

to most types of active business income earned abroad. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[677]

Subpart F,[678] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[679] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[680]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[681] insurance income,[682] and certain income relating to international boycotts and other violations of public policy.[683] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[684]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[685]

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

[678] Secs. 951-964.

[679] Secs. 951(b), 957, 958.

[680] Sec. 951(a).

[681] Sec. 954.

[682] Sec. 953.

[683] Sec. 952(a)(3)-(5).

[684] Sec. 954.

[685] Secs. 951(a)(1)(B), 956.

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[686] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[687] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[688] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[689]

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation's subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S. shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

<u>House Bill</u>

No provision.

<u>Senate Amendment</u>

The provision adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

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[686] Sec. 1297.

[687] Sec. 1293-1295.

[688] Sec. 1291.

[689] Sec. 1296.

Effective date.–The provision is effective for taxable years of foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Reduction of Fuel Tax Evasion

1. Exemption from certain excise taxes for mobile machinery vehicles and modification of definition of offhighway vehicle (sec. 651 of the House bill, sec. 896 of the Senate amendment, and secs. 4053, 4072, 4082, 4483, 6421, and 7701 of the Code)

Present Law

Under present law, the definition of a "highway vehicle" affects the application of the retail tax on heavy vehicles, the heavy vehicle use tax, the tax on tires, and fuel taxes.[690] Section 4051 of the Code provides for a 12-percent retail sales tax on tractors, heavy trucks with a gross vehicle weight ("GVW") over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 provides for a tax on highway vehicle tires that weigh more than 40 pounds, with higher rates of tax for heavier tires. Section 4481 provides for an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the Leaking Underground Storage Tank ("LUST") Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the LUST Trust Fund.

The Code does not define a "highway vehicle." For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for non-transportation functions (the "mobile machinery exception"); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the "off-highway transportation vehicle" exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance of non-transportation functions off the public highways.[691]

The mobile machinery exception applies if three tests are met: (1) the vehicle consists of a chassis to which jobsite machinery (unrelated to transportation) has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery; and (3) by reason of such special design, the chassis could not, without substantial structural modification, be used to transport a load other than the particular machinery. An example of a mobile machinery vehicle is a crane mounted on a truck chassis that meets the forgoing factors.

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[690] Secs. 4051, 4071, 4481, 4041 and 4081.

[691] See Treas. Reg. sec. 48.4061-1(d)).

On June 6, 2002, the Treasury Department put forth proposed regulations that would eliminate the mobile machinery exception.[692] The other exceptions from the definition of highway vehicle would continue to apply with some modifications. Under the proposed regulations, the chassis of a mobile machinery vehicle would be subject to the retail sales tax on heavy vehicles unless the vehicle qualified under the off-highway transportation vehicle exception. Also, under the proposed regulations, mobile machinery vehicles may be subject to the heavy vehicle use tax. In addition, the tax credits, refunds, and exemptions from tax may not be available for the fuel used in these vehicles.

On June 6, 2002, the Treasury Department put forth proposed regulations that would modify the off-highway transportation vehicle exception.[693] Under the proposed regulations, a vehicle is not treated as a highway vehicle if it is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design its capability to transport a load over the public highway is substantially limited or impaired. A vehicle's design is determined solely on the basis of its physical characteristics. In determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether it is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether it can transport a load at a sustained speed of at least 25 miles per hour. Under the proposed regulation, it is not material that a vehicle can transport a greater load off the public highway than it is permitted to transport over the public highway.

The proposed regulation provides an exception to the definition of a highway vehicle for nontransportation trailers and semitrailers.[694] Under the proposed regulation, a trailer or semitrailer is not treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an offhighway function at an offhighway site. For example, a trailer that is capable only of functioning as an office for an offhighway construction operation is not a highway vehicle.

<u>House Bill</u>

The provision codifies the present-law mobile machinery exemption for purposes of three taxes: the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. Thus, if a vehicle can satisfy the three-part test, it will not be treated as a highway vehicle and will be exempt from these taxes.

For purposes of the fuel excise tax, the three-part design test is codified and a use test is added by the provision. Specifically, in addition to the three-part design test, the vehicle must not have traveled more than 7,500 miles over public highways during the owner's taxable year. Refunds of fuel taxes are permitted on an annual basis only. For purposes of this rule, a person's taxable year is his taxable year for income tax purposes.

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[692] Prop. Treas. Reg. sec. 48.4051-1(a), 67 Fed. Reg. 38913, 38914-38915 (2002).

[693] Prop. Treas. Reg. sec. 48.4051-1(a)(2)(i).

[694] Prop. Treas. Reg. sec. 48.4051-1(a)(2)(ii).

Effective date.–The provision generally is effective after the date of enactment. As to the fuel taxes, the provision is effective for taxable years beginning after the date of enactment.

Senate Amendment

The Senate amendment provides that mobile machinery vehicles are subject to tax as highway vehicles. The provision provides for the recovery of taxes paid (other than fuel taxes) over a two-year period if such vehicle travels less than 5,000 miles per year. Fuel taxes for mobile machinery vehicles must be paid and then a refund sought if the mileage requirement is met. Refunds of fuel taxes are permitted on an annual basis only. Like the House bill, for purposes of this rule, a person's taxable year is his taxable year for income tax purposes. Vehicles owned by an organization described in section 501(c), exempt from tax under section 501(a), need only satisfy the three-part design test to recover taxes paid with respect to such vehicles.

Effective date.–The provision generally is effective after the date of enactment. As to the fuel taxes, the provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the House bill. Vehicles owned by an organization described in section 501(c), exempt from tax under section 501(a), need only satisfy the three-part design test to recover taxes paid with respect to such vehicles.

The conference agreement adopts the definition of an offhighway transportation vehicle and a nontransportation trailer and semitrailer described in Proposed Treasury Regulation section 48.4051-1(a)(2).

For example, as provided in the proposed regulations,[695] Vehicle C consists of a truck chassis on which an oversize body designed to transport and apply liquid agricultural chemicals on farms has been installed. It is capable of transporting a load over the public highway. It is 132 inches in width, which is considerably in excess of standard highway vehicle width. For travel on uneven and soft terrain, it is equipped with oversize wheels with high-flotation tires, and nonstandard axles, brakes, and transmission. It has a special fuel and carburetor air filtration system that enable it to perform efficiently in an environment of dirt and dust. It is not able to maintain a speed of 25 miles per hour for more than one mile while fully loaded. Because Vehicle C is a self-propelled vehicle capable of transporting a load over the public highway, it would meet the general definition of a highway vehicle. However, its considerable physical characteristics for transporting its load other than over the public highway, when compared with its physical characteristics for transporting the load over the public highway, establish that it is specially designed for the primary function of transporting its load other than over the public highway. Further, the physical characteristics for transporting its load other than over the public highway substantially limit its capability to transport a load over the public highway. Therefore, Vehicle C is an offhighway vehicle and is not treated as a highway vehicle.

[695] Prop. Treas. Reg. sec. 48.4051-1(c), *Example (3)*.

Effective date.–Generally effective after the date of enactment. As to the fuel taxes, effective for taxable years beginning after the date of enactment.

2. Taxation of aviation-grade kerosene (sec. 652 of the House bill, sec. 871 of the Senate amendment, and secs. 4041, 4081, 4082, 4083, 4091, 4092, 4093, 4101, and 6427 of the Code)

Present Law

In general

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.[696] Unlike other fuels that generally are taxed upon removal from a terminal rack,[697] aviation fuel is taxed upon sale of the fuel by a producer or importer.[698] Sales by a registered producer to another registered producer are exempt from tax, with the result that, as a practical matter, aviation fuel is not taxed until the fuel is used at the airport (or sold to an unregistered person). Use of untaxed aviation fuel by a producer is treated as a taxable sale.[699] The producer or importer is liable for the tax. The rate of tax on aviation fuel is 21.9 cents per gallon.[700]

The tax on aviation fuel is reported by filing Form 720 - Quarterly Federal Excise Tax Return. Generally, semi-monthly deposits are required using Form 8109B - Federal Tax Deposit Coupon or by depositing the tax by electronic funds transfer.

Partial exemptions

In general, aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.[701] Commercial aviation means any use of an aircraft in a business of

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[696] Sec. 4093(a).

[697] A rack is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel. Treas. Reg. sec. 48.4081-1(b).

[698] Sec. 4091(a)(1).

[699] Sec. 4091(a)(2).

[700] Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) and 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

[701] Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), and 4221(d)(3).

transporting persons or property for compensation or hire by air (unless the use is allocable to any transportation exempt from certain excise taxes).[702]

In order to qualify for the 4.4 cents per gallon rate, the person engaged in commercial aviation must be registered with the Secretary[703] and provide the seller with a written exemption certificate stating the airline's name, address, taxpayer identification number, registration number, and intended use of the fuel. A person that is registered as a buyer of aviation fuel for use in commercial aviation generally is assigned a registration number with a "Y" suffix (a "Y" registrant), which entitles the registrant to purchase aviation fuel at the 4.4 cents per gallon rate.

Large commercial airlines that also are producers of aviation fuel qualify for registration numbers with an "H" suffix. As producers of aviation fuel, "H" registrants may buy aviation fuel tax free pursuant to a full exemption that applies to sales of aviation fuel by a registered producer to a registered producer. If the "H" registrant ultimately uses such untaxed fuel in domestic commercial aviation, the H registrant is liable for the aviation fuel tax at the 4.4 cents per gallon rate.

Exemptions

Aviation fuel sold by a producer or importer for use by the buyer in a nontaxable use is exempt from the excise tax on sales of aviation fuel.[704] To qualify for the exemption, the buyer must provide the seller with a written exemption certificate stating the buyer's name, address, taxpayer identification number, registration number (if applicable), and intended use of the fuel.

Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions;[705] (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing

[702] Secs. 4092(b) and 4041(c)(2).

[703] Notice 88-132, sec. III(D). See also, Form 637 - Application for Registration (For Certain Excise Tax Activities). A bond may be required as a condition of registration.

[704] Sec. 4092(a).

[705] "Trade" includes the transportation of persons or property for hire. Treas. Reg. sec. 48.4221-4(b)(8).

aircraft for purposes of providing transportation with respect to which certain requirements are met.[706]

A producer that is registered with the Secretary may sell aviation fuel tax-free to another registered producer.[707] Producers include refiners, blenders, wholesale distributors of aviation fuel, dealers selling aviation fuel exclusively to producers of aviation fuel, the actual producer of the aviation fuel, and with respect to fuel purchased at a reduced rate, the purchaser of such fuel.

Refunds and credits

A claim for refund of taxed aviation fuel held by a registered aviation fuel producer is allowed[708] (without interest) if: (1) the aviation fuel tax was paid by an importer or producer (the "first producer") and the tax has not otherwise been credited or refunded; (2) the aviation fuel was acquired by a registered aviation fuel producer (the "second producer") after the tax was paid; (3) the second producer files a timely refund claim with the proper information; and (4) the first producer and any other person that owns the fuel after its sale by the first producer and before its purchase by the second producer have met certain reporting requirements.[709] Refund claims should contain the volume and type of aviation fuel, the date on which the second producer acquired the fuel, the amount of tax that the first producer paid, a statement by the claimant that the amount of tax was not collected nor included in the sales price of the fuel by the claimant when the fuel was sold to a subsequent purchaser, the name, address, and employer identification number of the first producer, and a copy of any required statement of a subsequent seller (subsequent to the first producer but prior to the second producer) that the second producer received. A claim for refund is filed on Form 8849, Claim for Refund of Excise Taxes, and may not be combined with any other refunds.[710]

A payment is allowable to the ultimate purchaser of taxed aviation fuel if the aviation fuel is used in a nontaxable use.[711] A claim for payment may be made on Form 8849 or on Form 720, Schedule C. A claim made on Form 720, Schedule C, may be netted against the claimant's excise tax liability.[712] Claims for payment not so taken may be allowable as income tax credits[713] on Form 4136, Credit for Federal Tax Paid on Fuels.

[706] Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 4092.

[707] Sec. 4092(c).

[708] Sec. 4091(d).

[709] Treas. Reg. sec. 48.4091-3(b).

[710] Treas. Reg. sec. 48.4091-3(d)(1).

[711] Sec. 6427(l)(1).

[712] Treas. Reg. sec. 40.6302(c)-1(a)(3).

[713] Sec. 34.

<u>**House Bill**</u>

The provision changes the incidence of taxation of aviation fuel from the sale of aviation fuel to the removal of aviation fuel from a refinery or terminal, or the entry into the United States of aviation fuel. Sales of not previously taxed aviation fuel to an unregistered person also are subject to tax.

Under the provision, the full rate of tax -- 21.9 cents per gallon -- is imposed upon removal of aviation fuel from a refinery or terminal (or entry into the United States). Aviation fuel may be removed at a reduced rate -- either 4.4 or zero cents per gallon -- only if the aviation fuel is: (1) removed directly into the wing of an aircraft (i) that is registered with the Secretary as a buyer of aviation fuel for use in commercial aviation (e.g., a "Y" registrant under current law), (ii) that is a foreign airline entitled to the present law exemption for aviation fuel used in foreign trade, or (iii) for a tax-exempt use; or (2) removed or entered as part of an exempt bulk transfer.[714] An exempt bulk transfer is a removal or entry of aviation fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the aviation fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.

Under a special rule, the provision treats certain refueler trucks, tankers, and tank wagons as a terminal if certain requirements are met. For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation fuel from a terminal: (1) that is located within an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. It is intended that a terminal is located within an airport if the terminal is located in a secure facility on airport grounds. For example, if an access road runs between a terminal and an airport's runways, and the terminal, like the runways, is physically located on airport grounds and is part of a secure facility, it is intended that under the provision the terminal is located within the airport. It is intended that an exigent circumstance under which loading a vehicle registered for highway use with fuel would not disqualify a terminal under the special rule would include, for example, the unloading of fuel from bulk storage tanks into highway vehicles in order to repair the storage tanks.

In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) deliver the aviation fuel directly into the wing of the aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be registered for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.[715]

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[714] See sec. 4081(a)(1)(B).

[715] The provision requires that if such delivery of information is provided to a terminal operator (or if a terminal operator collects such information), that the terminal operator provide such information to the Secretary.

The provision does not change the applicable rates of tax under present law, 21.9 cents per gallon for use in noncommercial aviation, 4.4 cents per gallon for use in commercial aviation, and zero cents per gallon for use by domestic airlines in an international flight, by foreign airlines, or other nontaxable use. The provision imposes liability for the tax on aviation fuel removed from a refinery or terminal directly into the wing of an aircraft for use in commercial aviation on the person receiving the fuel, in which case, such person self-assesses the tax on a return. The provision does not change present-law nontaxable uses of aviation fuel, or change the persons or the qualifications of persons who are entitled to purchase fuel at a reduced rate, except that a producer is not permitted to purchase aviation fuel at a reduced rate by reason of such persons' status as a producer.

Under the provision, a refund is allowable to the ultimate vendor of aviation fuel if such ultimate vendor purchases fuel tax paid and subsequently sells the fuel to a person qualified to purchase at a reduced rate and who waives the right to a refund. In such a case, the provision permits an ultimate vendor to net refund claims against any excise tax liability of the ultimate vendor, in a manner similar to the present law treatment of ultimate purchaser payment claims.[716]

As under present law, if previously taxed aviation fuel is used for a nontaxable use, the ultimate purchaser may claim a refund for the tax previously paid. If previously taxed aviation fuel is used for a taxable non aircraft use, the fuel is subject to the tax imposed on kerosene (24.4 cents per gallon) and a refund of the previously paid aviation fuel tax is allowed. Claims by the ultimate vendor or the purchaser that are not taken as refund claims may be allowable as income tax credits.

For example, for an airport that is not served by a pipeline, aviation fuel generally is removed from a terminal and transported to an airport storage facility for eventual use at the airport. In such a case, the aviation fuel will be taxed at 21.9 cents per gallon upon removal from the terminal. At the airport, if the fuel is purchased from a vendor by a person registered with the Secretary to use fuel in commercial aviation, the purchaser may buy the fuel at a reduced rate (generally, 4.4 cents per gallon for domestic flights and zero cents per gallon for international flights) and waive the right to a refund. The ultimate vendor generally may claim a refund for the difference between 21.9 cents per gallon of tax paid upon removal and the rate of tax paid to the vendor by the purchaser. To obtain a zero rate upon purchase, a registered domestic airline must certify to the vendor at the time of purchase that the fuel is for use in an international flight; otherwise, the airline must pay the 4.4 cents per gallon rate and file a claim for refund to the Secretary if the fuel is used for international aviation. If a zero rate is paid and the fuel subsequently is used in domestic and not international travel, the domestic airline is liable for tax at 4.4 cents per gallon. A foreign airline eligible under present law to purchase aviation fuel tax-free would continue to purchase such fuel tax-free.

As another example, for an airport that is served by a pipeline, aviation fuel generally is delivered to the wing of an aircraft either by a refueling truck or by a "hydrant" that runs directly

[716] For example, X is a commercial airline subsidiary of airline Y. If Y sells fuel to X, X can waive its right to a refund to Y as the ultimate vendor. Y would then be entitled to file for a refund or net the refund against its excise tax liability.

from the pipeline to the airplane wing. If a refueling truck that is not licensed for highway use loads fuel from a terminal located within the airport (and the other requirements of the provision for such truck and terminal are met), and delivers the fuel directly to the wing of an aircraft for use in commercial aviation, the aviation fuel is taxed at 4.4 cents per gallon upon delivery to the wing and the person receiving the fuel is liable for the tax, which such person would be able to self-assess on a return.[717] If fuel is loaded into a refueling truck that does not meet the requirements of the provision, then the fuel is treated as removed from the terminal into the refueling truck and tax of 21.9 cents per gallon is paid on such removal. The ultimate vendor is entitled to a refund of the difference between 21.9 cents per gallon paid on removal and the rate paid by a commercial airline purchaser (assuming the purchaser waived the refund right). If fuel is removed from a terminal directly to the wing of an aircraft registered to use fuel in commercial aviation by a hydrant or similar device, the person removing the aviation fuel is liable for a tax of 4.4 cents per gallon (or zero in the case of an international flight or qualified foreign airline) and may self-assess such tax on a return.

Under the provision, a floor stocks tax applies to aviation fuel held by a person (if title for such fuel has passed to such person) on October 1, 2004. The tax is equal to the amount of tax that would have been imposed before October 1, 2004, if the provision was in effect at all times before such date, reduced by the tax imposed by section 4091, as in effect on the day before the date of enactment. The Secretary shall determine the time and manner for payment of the tax, including the nonapplication of the tax on de minimis amounts of aviation fuel. Under the provision, 0.1 cents per gallon of such tax is transferred to the LUST Trust Fund. The remainder is transferred to the Airport and Airway Trust Fund.

<u>Effective date</u>.–Effective for aviation fuel removed, entered, or sold after September 30, 2004.

Senate Amendment

The Senate amendment is similar to the House bill, except that refueler trucks, tankers, and tank wagons are not subject to special rules, and there is no provision for liability for, and self-assessment of, tax by the person receiving fuel removed from a refinery or terminal directly into the wing of an aircraft (whether by refueling vehicle or otherwise).

<u>Effective date</u>.–Effective for aviation fuel removed, entered, or sold after September 30, 2004.

Conference Agreement

The conference agreement follows the House bill, with the following modifications. The rule that permits certain refueler trucks to be treated as a terminal for purposes of the provision is modified to require that, in addition to the requirements specified in the House bill, a qualifying

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[717] Alternatively, if the aviation fuel in the example is for use in noncommercial aviation, the fuel is taxed at 21.9 cents per gallon upon delivery into the wing. Self-assessment of the tax would not apply in such case.

truck, tanker, or tank wagon must be loaded with aviation fuel from a terminal that is located within a secured area of an airport. The Secretary is required to publish, by December 15, 2004, and maintain a list of airports that include a secured area in which a terminal is located.[718] In addition, the conference agreement modifes the requirement that in order to qualify for the special rule, a refueler truck, tanker, or tank wagon must deliver the aviation fuel directly into the wing of the aircraft at the airport where the terminal is located to a requirement that a refueler truck, tanker, or tank wagon be loaded with aviation fuel for delivery into aircraft at the airport where the terminal is located.

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[718] The conferees intend that the following airports, subject to verification by the Secretary, be included on the Secretary's initial list of airports that include a secured area in which a terminal is located. The airports are listed by airport name, and the terminal with respect to the airport is identified by terminal control number. In maintaining the list of qualified airports, the Secretary has the discretion to add or remove airports from the list. Ted Stevens International Airport, T-91-AK-4520; William B. Hartsfield Atlanta International Airport, T-58-GA-2512; William B. Hartsfield Atlanta International Airport, T-58-GA-2513; William B. Hartsfield Atlanta International Airport, T-58-GA-2536; Bradley International Airport, T-06-CT-1271; Nashville Metropolitan Airport, T-62-TN-2222; Logan International Airport, T-04-MA-1171; Baltimore/Washington International Airport, T-52-MD-1569; Cleveland Hopkins International Airport, T-31-OH-3109; Charlotte/Douglas International Airport, T-56-NC-2032; Colorado Springs Airport, T-84-CO-4108; Cincinnati/Northern Kentucky International Airport, T-61-KY-3277; Dallas Love Field Airport, T-75-TX-2663; Ronald Reagan National Airport, T-54-VA-1686; Denver International Airport, T-84-CO-4111; Dallas Fort Worth International Airport, T-75-TX-2673; Wayne County Metropolitan Airport, T-38-MI-3018; Newark Liberty International Airport, T-22-NJ-1532; Fort Lauderdale/Hollywood International Airport; T-65-FL-2158; Piedmont Triad International Airport, T-56-NC-2038; Honolulu International Airport, T-91-HI-4570; Dulles International Airport, T-54-VA-1676; George Bush Intercontinental Airport, T-76-TX-2818; Mid Continent Airport, T-43-KS-3653; John F. Kennedy International Airport, T-11-NY-1334; McCarren International Airport, T-86-NV-4355; Kansas City International Airport, T-43-MO-3723; Orlando International Airport, T-59-FL-2111; Midway Airport, T-36-IL-3376; Memphis International Airport, T-62-TN-2212; General Mitchell International Airport, T-39-WI-3092; Minneapolis-St. Paul International Airport, T-41-MN-3419; Minneapolis-St. Paul International Airport, T-41-MN-3420; Minneapolis-St. Paul International Airport, T-41-MN-3421; Louis Armstrong New Orleans International Airport, T-72-LA-2356; Oakland International Airport, T-94-CA-4702; Eppley Airfield, T-47-NE-3608; Ontario International Airport, T-33-CA-4792; O'Hare International Airport, T-36-IL-3325; Portland International Airport, T-91-OR-4450; Philadelphia International Airport, T-23-PA-1770; Sky Harbor International Airport, T-86-AZ-4302; Pittsburgh International Airport, T-23-PA-1766; Raleigh/Durham International, T-56-NC-2045; Reno Cannon International Airport, T-86-NV-4352; San Diego International Airport, T-33-CA-4788; San Antonio International Airport, pending; Seattle Tacoma International Airport, T-91-WA-4425; San Francisco International Airport, T-94-CA-4701; San Jose Municipal Airport, T-77-CA-4650; Salt Lake City International Airport, T-84-UT-4207; John Wayne Airport/Orange County, T-33-CA-4772; Lambert International Airport, T-43-MO-3722; Tampa/St. Petersburg International Airport, T-59-FL-2110.

The conference agreement modifies the floor stocks tax. Under the conference agreement, a floor stocks tax applies to aviation fuel held by a person (if title for such fuel has passed to such person) on January 1, 2004. The tax is equal to the amount of tax that would have been imposed before January 1, 2004, if the proposal was in effect at all times before such date, reduced by (1) the tax imposed by section 4091, as in effect on the day before such date and, (2) in the case of kerosene held exclusively for the holder's own use, the amount which such holder would reasonably expect under the proposal to be paid as a refund for a nontaxable use with respect to the kerosene. The tax does not apply to kerosene held in the fuel tank of an aircraft on January 1, 2004. The Secretary shall determine the time and manner for payment of the tax, including the nonapplication of the tax on de minimis amounts of aviation fuel. Under the conference agreement, 0.1 cents per gallon of such tax is transferred to the LUST Trust Fund. The remainder is transferred to the Airport and Airway Trust Fund.

The conferees expect the Secretary to delay the due date of the excise tax return with respect to aviation fuel for the quarter beginning on January 1, 2005. It is intended that the requirement of semi-monthly deposits of aviation fuel taxes continue unchanged.

Effective date.–Effective for aviation-grade kerosene removed, entered, or sold after December 31, 2004.

3. Provide for transfer from Airport and Airway Trust Fund to Highway Trust Fund to adjust for continued highway use of aviation fuel (sec. 872 of the Senate amendment and secs. 9502 and 9503 of the Code)

Present Law

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.[719] In general, the rate of tax on aviation fuel is 21.9 cents per gallon.[720] Aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.[721] Certain sales of aviation fuel are exempt from tax.[722]

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[719] Sec. 4093(a).

[720] Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) & 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

[721] Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), & 4221(d)(3).

[722] Sec. 4092.

Taxes received for aviation fuel, except for the LUST Trust Fund financing rate, are appropriated to the Airport and Airway Trust Fund.[723] Such appropriation occurs even if aviation fuel is used for non aviation purposes.

Taxes received on taxable fuel for transportation purposes generally are appropriated to the Highway Trust Fund.[724]

House Bill

No provision.

Senate Amendment

The provision directs the Secretary to transfer from the Airport and Airway Trust Fund to the Highway Trust Fund annually an amount equivalent to amounts received in the Airport and Airway Trust Fund which are attributable to fuel that is used primarily for highway transportation purposes. The Secretary is directed to transfer 11 percent of such amount to the Mass Transit Account.

Effective date.–Effective on October 1, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Mechanical dye injection and related penalties (sec. 653 of the House bill, secs. 873, 874 and 875 of the Senate amendment and secs. 4082 and 6715 and new sec. 6715A of the Code)

Present Law

Statutory rules

Gasoline, diesel fuel and kerosene are generally subject to excise tax upon removal from a refinery or terminal, upon importation into the United States, and upon sale to unregistered persons unless there was a prior taxable removal or importation of such fuels.[725] However, a tax is not imposed upon diesel fuel or kerosene if all of the following are met: (1) the Secretary determines that the fuel is destined for a nontaxable use, (2) the fuel is indelibly dyed in accordance with regulations prescribed by the Secretary,[726] and (3) the fuel meets marking

[723] Sec. 9502(b).

[724] Sec. 9503(b).

[725] Sec. 4081(a)(1)(A). If such fuel is used for a nontaxable purpose, the purchaser is entitled to a refund of tax paid, or in some cases, an income tax credit. *See* sec. 6427.

[726] Dyeing is not a requirement, however, for certain fuels under certain conditions, i.e., diesel fuel or kerosene exempted from dyeing in certain States by the EPA under the Clean Air

requirements prescribed by the Secretary.[727] A nontaxable use is defined as (1) any use that is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax, (2) any use in a train, or (3) certain uses in buses for public and school transportation, as described in section 6427(b)(1) (after application of section 6427(b)(3)).[728]

The Secretary is required to prescribe necessary regulations relating to dyeing, including specifically the labeling of retail diesel fuel and kerosene pumps.[729]

A person who sells dyed fuel (or holds dyed fuel for sale) for any use that such person knows (or has reason to know) is a taxable use, or who willfully alters or attempts to alter the dye in any dyed fuel, is subject to a penalty.[730] The penalty also applies to any person who uses dyed fuel for a taxable use (or holds dyed fuel for such a use) and who knows (or has reason to know) that the fuel is dyed.[731] The penalty is the greater of $1,000 per act or $10 per gallon of dyed fuel involved. In determining the amount of the penalty, the $1,000 is increased by the product of $1,000 and the number of prior penalties imposed upon such person (or a related person or predecessor of such person or related person).[732] The penalty may be imposed jointly and severally on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty.[733] For purposes of the penalty, the term "dyed fuel" means any dyed diesel fuel or kerosene, whether or not the fuel was dyed pursuant to section 4082.[734]

Act, aviation-grade kerosene as determined under regulations prescribed by the Secretary, kerosene received by pipeline or vessel and used by a registered recipient to produce substances (other than gasoline, diesel fuel or special fuels), kerosene removed or entered by a registrant to produce such substances or for resale, and (under regulations) kerosene sold by a registered distributor who sells kerosene exclusively to ultimate vendors that resell it (1) from a pump that is not suitable for fueling any diesel-powered highway vehicle or train, or (2) for blending with heating oil to be used during periods of extreme or unseasonable cold. Sec. 4082(c), (d).

[727] Sec. 4082(a).

[728] Sec. 4082(b).

[729] Sec. 4082(e).

[730] Sec. 6715(a).

[731] Sec. 6715(a).

[732] Sec. 6715(b).

[733] Sec. 6715(d).

[734] Sec. 6715(c)(1).

Regulations

The Secretary has prescribed certain regulations under this provision, including regulations that specify the allowable types and concentration of dye, that the person claiming the exemption must be a taxable fuel registrant, that the terminal must be an approved terminal (in the case of a removal from a terminal rack), and the contents of the notice to be posted on diesel fuel and kerosene pumps.[735] However, the regulations do not prescribe the time or method of adding the dye to taxable fuel.[736] Diesel fuel is usually dyed at a terminal rack by either manual dyeing or mechanical injection. The regulations also provide that a terminal operator is jointly and severally liable for unpaid tax if undyed diesel fuel or kerosene is removed and the terminal operator provides any person with documentation that such fuel is dyed.[737]

House Bill

With respect to terminals that offer dyed fuel, the provision eliminates manual dyeing of fuel and requires dyeing by a mechanical system. Not later than 180 days after enactment of this provision, the Secretary of the Treasury is to prescribe regulations establishing standards for tamper resistant mechanical injector dyeing. Such standards shall be reasonable, cost-effective, and establish levels of security commensurate with the applicable facility.

The provision adds an additional set of penalties for violation of the new rules. A penalty, equal to the greater of $25,000 or $10 for each gallon of fuel involved, applies to each act of tampering with a mechanical dye injection system. The person committing the act is also responsible for any unpaid tax on removed undyed fuel. A penalty of $1,000 is imposed upon the operator of a mechanical dye injection system for each failure to maintain the security standards for such system.[738] An additional penalty of $1,000 is imposed upon such operator for each day any such violation remains uncorrected after the first day such violation has been or reasonably should have been discovered. For purposes of the daily penalty, a violation may be corrected by shutting down the portion of the system causing the violation. If any of these penalties are imposed on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty. If such business entity is part of an affiliated group, the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty.

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[735] Treas. Reg. secs. 48.4082-1, -2.

[736] In March 2000, the IRS withdrew its Notice of Proposed Rulemaking PS-6-95 (61 F.R. 10490 (1996)) relating to dye injection systems. Announcement 2000-42, 2000-1 C.B. 949. The proposed regulation established standards for mechanical dye injection equipment and required terminal operators to report nonconforming dyeing to the IRS. *See also* Treas. Reg. sec. 48.4082-1(c), (d).

[737] Treas. Reg. sec. 48.4081-2(c).

[738] The operator remains liable under current Treas. Reg. sec. 48.4081-2(c) for any unpaid tax on removed undyed fuel.

Effective date.--The provision is effective 180 days after the date that the Secretary issues the required regulations. The Secretary must issue such regulations no later than 180 days after enactment.

Senate Amendment

The Senate amendment contains a mechanical dyeing provision similar to the provision in the House bill, except that the Secretary of the Treasury is to prescribe regulations establishing standards by June 30, 2004.

The Senate amendment also contains two additional provisions not in the House bill.

The Senate amendment denies administrative appeal or review for repeat offenders (more than two violations) of present law after a chemical analysis of the fuel, except in the case of a claim regarding fraud or mistake in the chemical analysis or error in the mathematical calculation of the amount of penalty.

The Senate amendment also extends present-law penalties to any person who knows that the strength or composition of any dye or marking in any dyed fuel has been altered, chemically or otherwise, and who sells (or holds for sale) such fuel for any use that the person knows or has reason to know is a taxable use of such fuel.

Effective date.–Penalties relating to mechanical dyeing systems are effective 180 days after the regulations are issued. The prohibition of certain administrative review is effective for penalties assessed after date of enactment. The extension of present law penalties is effective on date of enactment.

Conference Agreement

The conference agreement follows the House bill with respect to mechanical dye injection systems and related penalties. The conference agreement follows the Senate amendment with respect to denying administrative review to repeat offenders and extending present law penalties to any person who knows that the strength or composition of any dye or marking in any dyed fuel has been altered, chemically or otherwise, and who sells (or holds for sale) such fuel for any use that the person knows or has reason to know is a taxable use of such fuel.

5. Authority to inspect on-site records (sec. 654 of the House bill, sec. 877 of the Senate amendment, and sec. 4083 of the Code)

Present Law

The IRS is authorized to inspect any place where taxable fuel[739] is produced or stored (or may be stored). The inspection is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and

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[739] "Taxable fuel" means gasoline, diesel fuel, and kerosene. Sec. 4083(a).

(2) take and remove samples of taxable fuel. Places of inspection include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[740]

In conducting the inspection, the IRS may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept at the place of inspection to determine the excise tax liability under section 4081.[741]

House Bill

The provision expands the scope of the inspection to include any books, records, or shipping papers pertaining to taxable fuel located in any authorized inspection location.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and Senate amendment.

6. Assessable penalty for refusal of entry (sec. 878 of the Senate amendment and new sec. 6717 of the Code)

Present Law

The Internal Revenue Service is authorized to inspect any place where taxable fuel is produced or stored (or may be stored). As part of the inspection, the Internal Revenue Service is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection, include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[742]

In conducting the inspection, the Internal Revenue Service may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept to determine the excise tax liability under section 4081.[743] The Internal Revenue Service is authorized to establish inspection sites. A designated inspection site includes any State highway inspection

[740] Sec. 4083(c)(1)(A).

[741] Treas. Reg. sec. 48.4083-1(c)(1).

[742] Sec. 4083(c)(1)(A).

[743] Treas. Reg. sec. 48.4083-1(b)(2).

station, weigh station, agricultural inspection station, mobile station or other location designated by the Internal Revenue Service.[744]

Any person that refuses to allow an inspection is subject to a penalty in the amount of $1,000 for each refusal.[745] The IRS is not able to assess this penalty in the same manner as it would a tax. It must first seek the assistance of the Department of Justice to obtain a judgment. Assessable penalties are payable upon notice and demand by the Secretary and are assessed and collected in the same manner as taxes.[746]

House Bill

No provision.

Senate Amendment

In addition to the $1,000 penalty under present law, the Senate amendment imposes an assessable penalty with respect to the refusal of entry. The assessable penalty is $1,000 for such refusal. The penalty will not apply if it is shown that such failure is due to reasonable cause. If the penalty is imposed on a business entity, the proposal provides for joint and several liability with respect to each officer, employee, or agent of such entity or other contracting party who willfully participated in the act giving rise to the penalty. If the business entity is part of an affiliated group, the parent corporation also will be jointly and severally liable for the penalty.

Effective date.–The provision is effective on October 1, 2004.

Conference Agreement

The conference agreement follows the Senate amendment, except for effective date.

Effective date.–The provision is effective on January 1, 2005.

7. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries (sec. 655 of the House bill, sec. 879 of the Senate amendment, and sec. 4081 of the Code)

Present Law

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[747] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or

[744] Sec. 4083(c); Treas. Reg. sec. 48.4083-1(b)(1).

[745] Sec. 4083(c)(3) and 7342.

[746] Sec. 6671.

[747] Sec. 4081(a)(1)(A).

entry of a taxable fuel transferred in bulk (a "bulk transfer") to a terminal or refinery if both the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[748]

Present law does not require that the vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered refiner may transfer fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer to an unregistered person.

In general, the owner of the fuel is liable for payment of tax with respect to bulk transfers not received at an approved terminal or refinery.[749] The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.[750]

House Bill

The provision requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax.

The Secretary is required to publish periodically a list of all registered persons that are required to register.

Effective date.–Effective on October 1, 2004, except that the Secretary is required to publish the list of registered persons beginning on July 1, 2004.

Senate Amendment

Similar to the House bill, except that with respect to a bulk transfer on which no tax is paid, the Senate amendment imposes a penalty on any person who knowingly transfers taxable fuel in bulk to an unregistered person. The penalty is the greater of $10,000 or $1 per gallon and is increased for multiple prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause.

Effective date.–Effective on October 1, 2004, except that the Secretary is required to publish the list of persons required to register by June 30, 2004.

[748] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

[749] Treas. Reg. sec. 48.4081-3(e)(2).

[750] Treas. Reg. sec. 48.4081-3(b).

Conference Agreement

The conference agreement follows the House bill, modified to provide that the Secretary shall periodically publish a current list of persons required to register under the authority of section 6103(k)(7).

Effective date.–Effective on March 1, 2005, except that the Secretary is required to publish the list of persons required to register beginning on January 1, 2005.

8. Display of registration and penalties for failure to display registration and to register (secs. 656 and 657 of the House bill, secs. 880 and 882 of the Senate amendment, and secs. 4101, 7232, 7272 and new secs. 6718 and 6719 of the Code)

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[751] A non-assessable penalty for failure to register is $50.[752] A criminal penalty of $5,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[753]

House Bill

The provision requires that every operator of a vessel who is required to register with the Secretary display on each vessel used by the operator to transport fuel, proof of registration through an electronic identification device prescribed by the Secretary. A failure to display such proof of registration results in a penalty of $500 per month per vessel. The amount of the penalty is increased for multiple prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause.

The provision imposes a new assessable penalty for failure to register of $10,000 for each initial failure, plus $1,000 per day that the failure continues. No penalty is imposed upon a showing by the taxpayer of reasonable cause. In addition, the provision increases the present-law non-assessable penalty for failure to register from $50 to $10,000 and the present law criminal penalty for failure to register from $5,000 to $10,000.

Effective date.–The provision requiring display of registration is effective on October 1, 2004. The provision relating to penalties is effective for penalties imposed after September 30, 2004.

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[751] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) and (c)(1).

[752] Sec. 7272(a).

[753] Sec. 7232.

Senate Amendment

The Senate amendment is similar to House bill, except that the increase in the penalty for multiple prior violations for failure to display proof of registration is determined differently.

Effective date.–Effective on October 1, 2004, except that the penalties for failure to register are effective for failures pending or occurring after September 30, 2004.

Conference Agreement

The conference agreement follows the House bill except that the identification device is not required to be electronic.

Effective date.–The provision requiring display of registration is effective on January 1, 2005. The provision relating to penalties is effective for penalties imposed after December 31, 2004.

9. Registration of persons within foreign trade zones (sec. 881 of the Senate amendment and sec. 4101 of the Code)

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[754]

House Bill

No provision.

Senate Amendment

The Secretary shall require registration by any person that operates a terminal or refinery within a foreign trade zone or within a customs bonded storage facility, or holds an inventory position with respect to a taxable fuel in such a terminal.

Conference Agreement

The conference agreement follows the Senate amendment. It is intended that the Secretary shall establish a date by which persons required to register under the provision must be registered.

Effective date.–Effective on January 1, 2005.

[754] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

10. Penalties for failure to report (sec. 657 of the House bill, sec. 882 of the Senate amendment, and new sec. 6725 of the Code)

Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.[755] Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[756] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements. In general, the penalty for failure to file a report or a failure to furnish all of the required information in a report is $50 per report.[757]

House Bill

The provision imposes a new assessable penalty for failure to file a report or to furnish information required in a report required by the ExSTARS system. The penalty is $10,000 per failure with respect to each vessel or facility (e.g., a terminal or other facility) for which information is required to be furnished. No penalty is imposed upon a showing by the taxpayer of reasonable cause.

Effective date.–Effective for penalties imposed after September 30, 2004.

Senate Amendment

Similar to House bill, except for technical wording differences.

Effective date.–Effective for failures pending or occurring after September 30, 2004. The electronic reporting provision is effective on October 1, 2004.

Conference Agreement

The conference agreement follows the House bill.

Effective date.–Effective for penalties imposed after December 31, 2004.

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[755] Sec. 4010(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

[756] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

[757] Sec. 6721(a).

11. Electronic filing of required information reports (sec. 895 of the Senate amendment and sec. 4010 of the Code)

Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.[758] Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[759] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements.

House Bill

No provision.

Senate Amendment

The Senate amendment requires information reporting with respect to taxable fuels removed, entered, or transferred from any refinery, pipeline, or vessel that is registered. The proposal also requires that any person who must report under the ExSTARs systems and who has 25 or more reportable transactions in a month to report in electronic format.

Effective date.–Effective on October 1, 2005.

Conference Agreement

The conference agreement follows the Senate amendment except that the conference agreement does not adopt the information reporting requirement with respect to taxable fuels removed, entered, or transferred from any refinery, pipeline, or vessel that is registered.

Effective date.–Effective on January 1, 2006.

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[758] Sec. 4101(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

[759] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

12. Information reporting for persons claiming certain tax benefits (sec. 883 of the Senate amendment and new sec. 4104 of the Code)

Present Law

The Code provides an income tax credit for each gallon of ethanol and methanol derived from renewable sources (*e.g.*, biomass) used or sold as a fuel, or used to produce a qualified alcohol fuel mixture, such as gasohol. The amount of the credit is equal to 52 cents per gallon (ethanol)[760] and 60 cents per gallon (methanol).[761] This tax credit is provided to blenders of the alcohols with other taxable fuels, or to the retail sellers of unblended alcohol fuels. Part or all of the benefits of the income tax credit may be claimed through reduced excise taxes paid, either in reduced-tax sales or by expedited blender refunds on fully taxed sales of gasoline to obtain the benefit of the reduced rates. The amount of the income tax credit determined with respect to any alcohol is reduced to take into account any benefit provided by the reduced excise tax rates. To obtain a partial refund on fully taxed gasoline, the following requirements apply: (1) the claim must be for gasohol sold or used during a period of at least one week, (2) the claim must be for at least $200, and (3) the claim must be filed by the last day of the first quarter following the earliest quarter included in the claim. If the blender cannot meet these requirements, the blender must claim a credit on the blender's income tax return.

House Bill

No provision.

Senate Amendment

The Senate amendment requires persons claiming the Code benefits related to alcohol fuels and biodiesel fuels to provide such information related to such benefits and the coordination of such benefits as the Secretary may require to ensure the proper administration and use of such benefits. The Secretary may deny, revoke or suspend the registration of any person to enforce this requirement.

Effective date.–The provision is effective October 1, 2004.

Conference Agreement

The conference agreement follows the Senate amendment. Persons claiming excise tax benefits are to file quarterly information returns, rather than monthly.

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[760] The 52-cents-per-gallon credit is scheduled to decline to 51 cents per gallon beginning in calendar year 2005. The credit is scheduled to expire after the earlier of (1) expiration of the Highway Trust Fund excise taxes or (2) December 31, 2007.

[761] Ethanol produced by certain "small producers" is eligible for an additional producer tax credit of 10 cents per gallon. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons and whose annual production does not exceed 15 million gallons.

Effective date.–The provision is effective January 1, 2004.

13. Collection from Customs bond where importer not registered (sec. 658 of the House bill and sec. 884 of Senate amendment)

Present Law

Typically, gasoline, diesel fuel, and kerosene are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities that geographically are located closer to destination retail markets. A fuel is taxed when it "breaks bulk," *i.e.*, when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the "position holder," i.e., the person shown on the records of the terminal facility as owning the fuel.

Tax is also imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing.[762] This tax does not apply to any entry of a taxable fuel transferred in bulk to a terminal or refinery if the person entering the taxable fuel and the operator of such terminal or refinery are registered. The "enterer" is liable for the tax. An enterer generally means the importer of record (under customs law) with respect to the taxable fuel. However, if the importer of record is acting as an agent (a broker for example), the person for whom the agent is acting is the enterer. If there is no importer of record for taxable fuel entered into the United States, the owner of the taxable fuel at the time it is brought into the United States is the enterer. An importer's liability for Customs duties includes a liability for any internal revenue taxes that attach upon the importation of merchandise unless otherwise provided by law or regulation.[763]

As a part of the entry documentation, the importer, consignee, or an authorized agent usually is required to file a bond with Customs. The bond, among other things, guarantees that proper entry summary, with payment of estimated duties and taxes when due, will be made for imported merchandise and that any additional duties and taxes subsequently found to be due will be paid.

As a condition of permitting anyone to be registered with the IRS, under section 4101 of the Code, the Secretary may require that such person give a bond in such sum as the Secretary determines appropriate.

On July 31, 2004, the Department of Treasury issued regulations providing that effective September 28, 2004, importers and enterers are jointly and severally liable for the tax on imported fuel if the importer is not the enterer and the enterer is not registered with the Secretary.

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[762] Sec. 4081(a)(1)(A)(iii).

[763] 19 C.F.R. sec. 141.3 (2004).

House Bill

Under the provision, the importer of record is jointly and severally liable for the tax imposed upon entry of fuel into the United States if, under regulations, any other person that is not registered with the Secretary as a taxable fuel registrant is liable for such tax. If the importer of record is liable for the tax and such tax is not paid on or before the last date prescribed for payment, the Secretary may collect such tax from the Customs bond posted with respect to the importation of the taxable fuel to which the tax relates.

For purposes of determining the jurisdiction of any court of the United States or any agency of the United States, any action by the Secretary to collect the tax from the Customs bond is treated as an action to collect tax from a bond authorized by section 4101 of the Code, not as an action to collect from a bond relating to the importation of merchandise.

Effective date.–The provision is effective for fuel entered after September 30, 2004.

Senate Amendment

Under the Senate amendment, for fuel entering the United States (other than transfers in bulk) for consumption, use, or warehousing, the proposal provides that the tax is immediately due and payable at the time of entry, if the enterer is not registered with the IRS. Upon the failure to pay tax or post bond, the Customs Service is authorized under the proposal to deny entry of the shipment into the United States. The Secretary also may seize the fuel on which the tax is due or detain the vehicle transporting such fuel until such tax is paid. If no tax has been paid or bond filed within five days of the seizure, the Secretary may sell the fuel.

Effective date.–The provision is effective upon date of enactment.

Conference Agreement

The conference agreement does not contain the House bill or Senate amendment provisions.

14. Reconciliation of on-loaded cargo to entered cargo (sec. 885 of the Senate amendment)

Present Law

The Trade Act of 2002 directed the Secretary to promulgate regulations pertaining to the electronic transmission to the Bureau of Customs and Border Patrol ("Customs") of information pertaining to cargo destined for importation into the United States or exportation from the United States, prior to such importation or exportation.[764] The Department of the Treasury issued final regulations on October 31, 2002. The regulations require the advance and accurate presentation of certain manifest information prior to lading at the foreign port and encourage the presentation of this information electronically. Customs must receive from the carrier the vessel's Cargo Declaration (Customs Form 1302) or the electronic equivalent within 24 hours before such cargo

[764] Sec. 343(a) of Pub. L. No. 107-210 (2002).

is laden aboard the vessel at the foreign port.[765] Certain carriers of bulk cargo, however, are exempt from these filing requirements. Such bulk cargo includes that composed of free flowing articles such as oil, grain, coal, ore and the like, which can be pumped or run through a chute or handled by dumping.[766] Thus, taxable fuels are not covered by the Cargo Declaration requirement.

House Bill

No provision.

Senate Amendment

The Senate amendment requires that, not later than one year after the date of enactment, the Secretary of Homeland Security, together with the Secretary, promulgate regulations providing for the transmission to the Internal Revenue Service of information pertaining to cargo of taxable fuels destined for importation into the United States, prior to such importations. The provision requires that imports of taxable fuels be subject to the Cargo Declaration and electronic reporting requirements.

Effective date.–The provision is effective upon date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Modification of the use tax on heavy highway vehicles (sec. 659 of the House bill, sec. 890 of the Senate amendment, and secs. 4481, 4483 and 6165 of the Code)

Present Law

An annual use tax is imposed on heavy highway vehicles, at the rates below.[767]

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers

[765] 19 CFR sec. 4.7(b)(2).

[766] 19 CFR sec. 4.7(b)(4)(i)(A).

[767] Sec. 4481.

are allowed to pay the tax in installments.[768] State governments are required to receive proof of payment of the use tax as a condition of vehicle registration.

Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[769] Any highway motor vehicle that is issued a base plate by Canada or Mexico and is operated on U.S. highways is subject to the highway use tax whether or not the vehicles are required to be registered in the United States. The tax rate for Canadian and Mexican vehicles is 75 percent of the rate that would otherwise be imposed.[770]

House Bill

The House bill eliminates the ability to pay the tax in installments. It also eliminates the reduced rates for Canadian and Mexican vehicles. The provision requires taxpayers with 25 or more vehicles for any taxable period to file their returns electronically. Finally, the provision permits proration of tax for vehicles sold during the taxable period.

Effective date.–The provision is effective for taxable periods beginning after the date of enactment.

Senate Amendment

The Senate amendment eliminates the ability to pay the tax in installments and allows no proration of the tax unless the vehicle is destroyed, stolen, or sold. It also eliminates the reduced rates for Canadian and Mexican vehicles. In addition, under regulations to be prescribed by the Secretary, every taxpayer that pays the heavy highway vehicle use tax to receive and display on the vehicle an electronic identification device as prescribed by the Secretary. The device is to be received and displayed not later than one month after the due date of the return of tax with respect to each taxable period.

Effective date.–The Senate amendment is generally effective for taxable periods beginning after the date of enactment. Requires the Secretary to issue regulations regarding electronic identification devices no later than October 1, 2005.

Conference Agreement

The conference agreement follows the House bill.

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[768] Sec. 6156.

[769] See generally, sec. 4483.

[770] Sec. 4483(f): Treas. Reg. sec. 41.4483-7(a).

16. Modification of ultimate vendor refund claims with respect to farming (sec. 660 of the House bill, sec. 887 of the Senate amendment, and sec. 6427 of the Code)

Present Law

In general, the Code provides that, if diesel fuel, kerosene, or aviation fuel on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) the amount of tax imposed. The refund is made to the ultimate purchaser of the taxed fuel. However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, refund payments are paid to the ultimate, registered vendors ("ultimate vendors") of such fuels.

House Bill

In the case of diesel fuel or kerosene used on a farm for farming purposes, the House bill provision limits ultimate vendor claims for refund to sales of such fuel in amounts less than 250 gallons per farmer per claim.

Effective date.–The provision is effective for fuels sold for nontaxable use after the date of enactment.

Senate Amendment

The Senate amendment provision is the same as the House bill except the limit on ultimate vendor claims is amounts less than 500 gallons per farmer per claim.

Conference Agreement

The conference agreement does not include the House bill provision or the Senate amendment provision.

17. Dedication of revenue from certain penalties to the Highway Trust Fund (sec. 661 of the House bill, sec. 891 of the Senate amendment, and sec. 9503 of the Code)

Present Law

Present law does not dedicate to the Highway Trust Fund any penalties assessed and collected by the Secretary.

House bill

The provision dedicates to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715 (relating to dyed fuel sold for use or used in taxable use), 6715A (penalty for tampering or failing to maintain security requirements for mechanical dye injection systems), 6717 (penalty for failing to display tax registration on vessels), 6718 (penalty for failing to register under section 4101), 6725 (penalty for failing to report information required by the Secretary), 7232 (penalty for failing to register and false representations of registration status), and 7272 (but only with regard to penalties related to failure to register under section 4101).

Effective date.–The provision is effective for penalties assessed after October 1, 2004.

Senate Amendment

The Senate amendment similarly dedicates certain penalties to the Highway Trust Fund.

Effective date.–The provision is effective for penalties assessed after October 1, 2004.

Conference Agreement

The conference agreement generally follows the House bill and the Senate amendment by dedicating certain penalties to the Highway Trust Fund. The conference agreement dedicates to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715 (relating to dyed fuel sold for use or used in taxable use), 6715A (penalty for tampering with or failing to maintain security requirements for mechanical dye injection systems), 6717 (assessable penalty for refusal of entry), 6718 (penalty for failing to display tax registration on vessels), 6719 (assessable penalty for failure to register), 6725 (penalty for failing to report information required by the Secretary), 7232 (penalty for failing to register and false representations of registration status), and 7272 (but only with regard to penalties related to failure to register under section 4101).

Effective date.–The provision is effective for penalties assessed on or after the date of enactment.

18. Taxable fuel refunds for certain ultimate vendors (sec. 662 of the House bill, sec. 888 of the Senate amendment, and secs. 6416 and 6427 of the Code)

Present Law

The Code provides that, in the case of gasoline on which tax has been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, a wholesale distributor that sells the gasoline for such exempt purposes is treated as the person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid. In the case of undyed diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, a credit or payment is allowable only to the ultimate, registered vendors ("ultimate vendors") of such fuels.

In general, refunds are paid without interest. However, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, the Secretary is required to pay interest on certain refunds. The Secretary must pay interest on refunds of $200 or more ($100 or more in the case of kerosene) due to the taxpayer arising from sales over any period of a week or more, if the Secretary does not make payment of the refund within 20 days.

House Bill

The provision provides that for sales of gasoline to a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, the provision conforms the payment of refunds to that procedure established under present law in the case of diesel fuel or kerosene. That is, the ultimate vendor claims the refund.

For claims for refund of tax paid on diesel fuel or kerosene sold to State and local governments and for claims for refund of tax paid on gasoline sold to State and local governments or to a nonprofit educational organization and for which the ultimate purchaser utilized a credit card, the provision deems the person extending the credit to the ultimate purchaser to be the ultimate vendor. That is, the credit card company administers claims for refund and is responsible for supplying documentation required from ultimate vendors.

Effective date.–The provision is effective October 1, 2004.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and Senate amendment, with modifications. For sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, claims for credits or refund are made by the ultimate vendor.

The conference agreement provides that the rules for vendor refunds apply to claims made under this provision, except that the rules regarding electronic claims shall not apply unless the ultimate vendor has certified to the Secretary for the most recent quarter of the taxable year that all ultimate purchasers of the vendor are State or local governments or to a nonprofit educational organizations.[771]

The conference agreement does not include the House bill or Senate amendment provisions that deem the person extending credit via a credit card to the ultimate purchaser to be the ultimate vendor for purposes of refund claims.

Effective date.–The provision is effective on January 1, 2005.

[771] Sec. 6416(b)(2)(C) or (D).

19. Two party exchanges (sec. 663 of the bill and new sec. 4105 of the Code)

Present Law

Most fuel is taxed when it is removed from a registered terminal.[772] The party liable for payment of this tax is the "position holder." The position holder is the person reflected on the records of the terminal operator as holding the inventory position in the fuel.[773]

It is common industry practice for oil companies to serve customers of other oil companies under exchange agreements, *e.g.*, where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) owns the fuel when the motor fuel is removed from the terminal and sold to B's customer.

House Bill

The provision permits two registered parties to switch position holder status in fuel within a registered terminal (thereby relieving the person originally owning the fuel[774] of tax liability as the position holder) if all of the following occur:

(1) The transaction includes a transfer from the original owner, i.e., the person who holds the original inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator prior to the transaction.

(2) The exchange transaction occurs before or at the same time as completion of removal across the rack from the terminal by the receiving person or its customer.

(3) The terminal operator in its books and records treats the receiving person as the person that removes the product across a terminal rack for purposes of reporting the transaction to the Internal Revenue Service.

(4) The transaction is the subject of a written contract.

Effective date.–The provision is effective on the date of enactment.

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[772] A "terminal" is a storage and distribution facility that is supplied by pipeline or vessel, and from which fuel may be removed at a rack. A "rack" is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel.

[773] Such person has a contractual agreement with the terminal operator to store and provide services with respect to the fuel. A "terminal operator" is any person who owns, operates, or otherwise controls a terminal. A terminal operator can also be a position holder if that person owns fuel in its terminal.

[774] In the provision, this person is referred to as the "delivering person."

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and Senate amendment.

20. Simplification of tax on tires (sec. 664 of the House bill and sec. 4071 of the Code)

Present Law

A graduated excise tax is imposed on the sale by a manufacturer (or importer) of tires designed for use on highway vehicles (sec. 4071). The tire tax rates are as follows:

Tire Weight	Tax Rate
Not more than 40 lbs.	No tax
More than 40 lbs., but not more than 70 lbs.	15 cents/lb. in excess of 40 lbs.
More than 70 lbs., but not more than 90 lbs	$4.50 plus 30 cents/lb. in excess of 70 lbs.
More than 90 lbs.	$10.50 plus 50 cents/lb. in excess of 90 lbs.

No tax is imposed on the recapping of a tire that previously has been subject to tax. Tires of extruded tiring with internal wire fastening also are exempt.

The tax expires after September 30, 2005.

House Bill

The House bill modifies the excise tax applicable to tires. The House bill replaces the present-law tax rates based on the weight of the tire with a tax rate based on the load capacity of the tire. In general, the tax is 9.4 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. In the case of a biasply tire, the tax rate is 4.7 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds.

The House bill modifies the definition of tires for use on highway vehicles to include any tire marked for highway use pursuant to certain regulations promulgated by the Secretary of Transportation. The provision also exempts from tax any tire sold for the exclusive use of the United States Department of Defense or the United States Coast Guard.

Tire load capacity is the maximum load rating labeled on the tire pursuant to regulations promulgated by the Secretary of Transportation. A biasply tire is any tire manufactured primarily for use on piggyback trailers.

Effective date.–The provision is effective for sales in calendar years beginning more than 30 days after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with the following modifications. The conference agreement modifies the rate of tax applicable to 9.45 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. In the case of a biasply tire, the conference agreement modifies the tax rate is 4.725 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. The conference agreement also imposes tax at a rate of is 4.725 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds an any super single tire. A super single tire is a single tire greater than 13 inches in cross section width designed to replace two tires in a dual fitment. The conference agreement provides that a biasply tire means a pneumatic tire on which the ply cords that extend to the beads are laid at alternate angles substantially less than 90 degrees to the centerline of the tread.

Nothing in the amendments made by this section shall be construed to have any effect on subsection (d) of section 48.4701-1 of Title 26, Code of Federal Regulations (relating to recapped and retreaded tires). The conferees expect that the Secretary will prescribe regulations implementing the amendment to section 4071 but that such regulations will not affect subsection (d). The conferees believe no tax should be imposed on the recapping of a tire that previously has been subject to tax.

Effective date.-- The provision is effective for sales in calendar years beginning more than 30 days after the date of enactment.

21. Tax on sale of diesel fuel whether suitable for use or not in a diesel-powered vehicle or train (sec. 886 of the Senate amendment)

Present Law

Under section 4081(a)(1), an excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not a taxable fuel registrant under section 4101, unless there was a prior taxable removal or entry.

Under section 4083(a), taxable fuel includes diesel fuel. Diesel fuel includes any liquid, other than gasoline, that without further processing or blending, is suitable for use as a fuel in a diesel-powered highway vehicle or train.[775] A liquid is suitable for this use if the liquid has practical and commercial fitness for use in the propulsion engine of a diesel-powered highway vehicle or diesel-powered train. A liquid may possess this practical and commercial fitness even though the specified use is not the liquid's predominant use. However, a liquid does not possess this practical and commercial fitness solely by reason of its possible or rare use as a fuel in the propulsion engine of a diesel-powered highway vehicle or diesel-powered train.

[775] Sec. 4083(a)(3).

A tax is imposed on the removal or sale of blended taxable fuel by the blender thereof.[776] Tax is computed on the difference between the total number of gallons of blended taxable fuel removed or sold and the number of gallons of previously taxed taxable fuel used to produce the blended taxable fuel.[777] Blended taxable fuel means any taxable fuel that is produced outside the bulk transfer/terminal system by mixing (1) taxable fuel with respect to which tax has been imposed under section 4041(a)(1) or 4081(a) (other than taxable fuel for which a credit or payment has been allowed); and (2) any other liquid on which tax has not been imposed under section 4081.[778]

The blender (the person making the blended taxable fuel) is liable for the tax on the increased volume. In addition, on and after April 2, 2003, a person that sells any liquid that is used to produce blended taxable fuel is jointly and severally liable for the tax on the removal or sale of that blended taxable fuel if the liquid is a liquid on which tax has not been imposed under section 4081; and is sold by that person as gasoline, diesel fuel, or kerosene that has been taxed under section 4081.[779]

House Bill

No provision.

Senate Amendment

The provision modifies the definition of diesel fuel to include any liquid which is sold as or offered for sale as a fuel in a diesel-powered highway vehicle or diesel-powered train.

Effective date.–The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

22. Nonapplication of export exemption to delivery of fuel to motor vehicles removed from United States (sec. 892 of the Senate amendment)

Present Law

A manufacturer's excise tax is imposed upon

(1) The removal of any taxable fuel from a refinery or terminal;

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[776] Sec. 4081(b).

[777] Treas. Reg. sec. 48.4081-3(g)(1).

[778] Treas. Reg. sec. 48.4081-1(c)(1)(i).

[779] Treas. Reg. sec. 48.4081-3(g)(2).

(2) The entry of any taxable fuel into the United States for consumption, use or warehousing; or

(3) The sale of any taxable fuel to any person who is not registered, unless there was a prior taxable removal or entry.[780]

The term "taxable fuel" means gasoline, diesel fuel and kerosene.

Special provisions under the Code provide for a refund of tax to any person who sells gasoline to another for exportation.[781] Section 6421(c) provides "If gasoline is sold to any person for any purpose described in paragraph (2), (3), (4), or (5) of section 4221(a), the Secretary shall pay (without interest) to such person an amount equal to the product of the number of gallons so sold multiplied by the rate at which tax was imposed on such gasoline by section 4081." Section 4221 provides, in pertinent part, "Under regulations prescribed by the Secretary, no tax shall be imposed under this chapter. . . on the sale by the manufacturer . . of an article--. . . for export, or for resale by the purchaser to a second purchaser for export . . . but only if such exportation or use is to occur before any other use . . ."

It is the IRS administrative position that the exemption from manufacturers excise tax by reason of exportation does not apply to the sale of motor fuel pumped into a fuel tank of a vehicle that is to be driven, or shipped, directly out of the United States.[782]

A duty-free sales facility that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales facility on which neither Federal duty nor Federal tax has been assessed pending exportation from the customs territory of the United States. The statutes covering duty-free facilities do not contain any limitation on what goods may qualify for duty-free treatment.

The United States Court of Federal Claims ("Claims Court") and a District Court in Michigan have taken different positions on whether fuel sold from a duty-free facility and placed into the tank of an automobile that is then driven out of the country is exported fuel.[783] Both

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[780] Sec. 4081(a)(1).

[781] Secs. 6421(c) and 4221(a)(2).

[782] Rev. Rul. 69-150.

[783] *See*, *Ammex Inc. v. United States*, 52 Fed. Cl. 303 (2002) (on cross-motions for summary judgment, the court found that plaintiff established standing to proceed to trial pursuant to sec. 6421(c) respecting its gasoline purchases only); and *Ammex Inc. v. United States*, 2002 U.S. Dist. LEXIS 25771 (E.D. Mich. July 31, 2002) (granting defendant's motion for summary judgment), reconsideration denied, *Ammex, Inc. v. United States*, 2002 U.S. Dist. LEXIS 22893 (E.D. Mich. Oct. 22, 2002). Although the Claims Court ruled that Ammex had standing to challenge the excise tax on gasoline, it subsequently held that Ammex was not entitled to a payment pursuant to sec. 6421(c) because it failed to prove at trial that it did not pass the tax on

cases involved the same duty-free facility, which is near the Canadian border and is configured in such a way that anyone leaving the facility must depart the United States and enter into Canada. The District Court agreed with the IRS position that such fuel is not exported, while the Claims Court reached the opposite conclusion. The Claims Court concluded that the act of exportation began with the consumer's purchase and that the fuel necessarily enters into the stream of exportation at the moment it is placed into the fuel supply tank and the customer drives into Canada.

House Bill

No provision.

Senate Amendment

The provision reaffirms the long-standing IRS position taken in Rev. Rul. 69-150 and restates present law by amending the Code definition of export to exclude the delivery of a taxable fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States. It also imposes a tax on the sale of taxable fuel at a duty-free sales enterprise unless there was a prior taxable removal, or entry of such fuel.

Effective date.–The provision applies to sales or deliveries made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

23. Taxation of transmix and diesel fuel blend stocks and Treasury study on fuel tax compliance (secs. 893, 894 and 895 of the Senate amendment and sec. 4083 of the Code)

Present Law

Definition of taxable fuels

A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[784]

Under the regulations, "gasoline" includes all products commonly or commercially known or sold as gasoline and suited for use as a motor fuel, and that have an octane rating of 75 or more. Gasoline also includes, to the extent provided in regulations, gasoline blendstocks and products commonly used as additives in gasoline. The term "gasoline blendstocks" does not

to its customers. *Ammex Inc. v. United States*, 2003 U.S. Claims LEXIS 63 (Fed. Cl. Mar. 26, 2003).

[784] Sec. 4083(a).

include any product that cannot be blended into gasoline without further processing or fractionation ("off-spec gasoline").[785]

Diesel fuel is any liquid (other than gasoline) that is suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train.[786] By regulation, diesel fuel does not include kerosene, gasoline, No. 5 and No. 6 fuel oils (as described in ASTM Specification D 396), or F-76 (Fuel Naval Distillates MIL-F-16884) any liquid that contains less than four percent normal parafins, or any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less and minimum color of +27 Saybolt (these are known as "excluded liquids").[787]

By regulation, kerosene is defined as the kerosene described in ASTM Specification D 3699 (No. 1-K and No. 2-K), ASTM Specification D 1655 (kerosene-type jet fuel), and military specifications MIL-DTL-5624T (Grade JP-5) and MIL-DTL-83133E (Grade JP-8). Kerosene does not include any liquid that is an excluded liquid.[788]

Taxable events and exemptions

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[789] The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[790]

Gasoline exemptions

If certain conditions are met, the removal, entry, or sale of gasoline blendstocks is not taxable. Generally, the exemption from tax applies if a gasoline blendstock is not used to

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[785] Treas. Reg. sec. 48.4081-1(c)(3)(ii). The term "gasoline blendstocks" means alkylate; butane; catalytically cracked gasoline; coker gasoline; ethyl tertiary butyl ether (ETBE); hexane; hydrocrackate; isomerate; methyl tertiary butyl ether (MTBE); mixed xylene (not including any separated isomer of xylene); natural gasoline; pentane; pentane mixture; polymer gasoline; raffinate; reformate; straight-run gasoline; straight-run naphtha; tertiary amyl methyl ether (TAME); tertiary butyl alcohol (gasoline grade) (TBA); thermally cracked gasoline; toluene; and transmix containing gasoline. Treas. Reg. sec. 48.4081-1(c)(3)(i).

[786] Sec. 4083(a)(3).

[787] Treas. Reg. sec. 48.4081-1(c)(2)(ii).

[788] Treas. Reg. sec. 48.4081-1(b).

[789] Sec. 4081(a)(1).

[790] Sec. 4081(a)(1)(B).

produce finished gasoline or is received at an approved terminal or refinery. No tax is imposed on nonbulk removals from a terminal or refinery, or nonbulk entries into the United States or on any gasoline blendstocks if the person liable for the tax is a gasoline registrant, has an unexpired notification certificate, knows of no false information in the certificate, and has verified the accuracy of the notification certificate. The sale of a gasoline blendstock that was not subject to tax on nonbulk removal or entry is taxable unless the seller has an unexpired certificate from the buyer and has no reason to believe that any information in the certificate is false. No tax is imposed on, or purchaser certification required for, off-spec gasoline.

Diesel fuel and kerosene exemptions

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Undyed aviation-grade kerosene also is exempt from tax at the rack if it is destined for use as a fuel in an aircraft. The tax does not apply to diesel fuel asserted to be "not suitable for use" or kerosene asserted to qualify as an excluded liquid.

Feedstock kerosene that a registered industrial user receives by pipeline or vessel also is exempt from the dyeing requirement. A kerosene feedstock user is defined as a person that receives kerosene by bulk transfer for its own use in the manufacture or production of any substance (other than gasoline, diesel fuel or special fuels subject to tax). Thus, for example, kerosene is used for a feedstock purpose when it is used as an ingredient in the production of paint and is not used for a feedstock purpose when it is used to power machinery at a factory where paint is produced. The person receiving the kerosene must be registered with the IRS and provide a certificate noting that the kerosene will be used for a feedstock purpose in order for the exemption to apply.

Information and tax return reporting

The IRS collects data under the ExSTARS reporting system that tracks all removals across the terminal rack regardless of whether or not the product is technically excluded from the definition of gasoline, diesel or blendstocks. ExSTARS reporting identifies the position holder at the time of removal. Below the rack, no information is gathered for exempt or excluded products or uses.

Taxpayers file quarterly excise tax returns showing only net taxable gallons.[791] Taxpayers do not account for gallons they claim to be exempt on such returns. Although the return is a quarterly return, the excise taxes are paid in semimonthly deposits.[792] If deposits are not made as required, a taxpayer may be required to file returns on a monthly or semimonthly basis instead of quarterly.[793]

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[791] Treas. Reg. sec. 406011(a)-1(a); Form 720, Quarterly Federal Excise Tax Return.

[792] Treas. Reg. 40.6302(c)-1(a).

[793] Treas. Reg. 40.6011(a)-1(b).

House Bill

No provision.

Senate Amendment

The Senate amendment creates a new category of taxable liquids, "reportable liquids". A reportable liquid is any petroleum-based liquid other than a taxable fuel. For purposes of the imposition of tax, the provision treats "reportable liquids" in a manner similar to taxable fuels. Tax is imposed upon the removal, entry, or sale of such liquids, unless the removal, entry, or sale is (1) to a registered person who certifies that such liquid will not be used as a fuel or in the production of a fuel, or (2) the sale is to the ultimate purchaser of such liquid. Under the provision, the current exclusions for distillates not suitable for use in a highway vehicle, excluded liquids, and gasoline blendstocks requiring further processing (off-spec gasoline) are eliminated. The provision also provides that dyed diesel (a taxable fuel) also is taxable unless removed by a taxable fuel registrant (a person registered with the Secretary under section 4101).

The provision authorizes the Secretary to pay (without interest) an amount equal to the tax imposed, if a person establishes that the ultimate use of a gasoline blendstock, or additive, was not to produce gasoline. Similarly, if tax is imposed on a reportable liquid and the person establishes that the liquid was not used to produce a taxable, fuel, the Secretary is authorized to pay (without interest) an amount equal to the tax imposed on such person with respect to the reportable liquid.

Taxpayers are to file a monthly fuel excise tax return. Not earlier than January 1, 2005, such filings shall be in electronic form as prescribed by the Secretary. In addition, under the provision, the Secretary is to require that all persons removing refined product, whether a taxable product or an untaxed product, over the terminal rack to report such products on an excise tax return. The return is to specifically identify the class of product and its quantity.[794]

Effective date.–The provision is effective for fuel sold or used after September 30, 2004.

Conference Agreement

The conference agreement adds two new categories to the definition of diesel fuel. Under the conference agreement, diesel fuel means: (1) any liquid (other than gasoline) which is suitable for use as a fuel in a diesel-powered highway vehicle, or a diesel-powered train; (2) transmix; and (3) diesel fuel blend stocks as identified by the Secretary. Transmix means a by-product of refined products pipeline operations created by the mixing of different specification products during pipeline transportation. Transmix generally results when one fuel, such as diesel fuel, is placed in a pipeline followed by another taxable fuel, such as kerosene. The mixture created between the two fuels when it is neither all diesel fuel nor all kerosene, is an example of a transmix. Under the conference agreement, all transmix is taxable as diesel fuel, regardless of whether it contains gasoline.

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[794] Persons not liable for tax, will make their reports in the same manner as taxpayers who file fuel excise tax returns as described above.

Under the conference agreement, it is intended that the re-refining of tax-paid transmix into gasoline, diesel fuel or kerosene qualify as a nontaxable off-highway business use of such transmix, for purposes of the refund and payment provisions relating to nontaxable uses of diesel fuel.

Not later than January 31, 2005, the Secretary shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report regarding fuel tax compliance, which shall include information, and analysis as specified below, and recommendations to address the issues identified.

The Secretary is to identify chemical products that should be added to the list of blendstocks. The Secretary is to identify those chemical products, as identified by lab analysis of fuel samples taken by the IRS, that have been blended with taxable fuel but are not currently treated as a blendstock. The report should indicate, to the extent possible, any statistics as to the frequency in which such chemical product has been discovered, and whether the samples contained above-normal concentrations of such chemical product. The report also shall include a discussion of IRS findings regarding the addition of waste products to taxable fuel and any recommendations to address the taxation of such products. The report shall include a discussion of IRS findings regarding sales of taxable fuel to entities claiming exempt status as a State or local government. Such discussion shall include the frequency of erroneous certifications as to exempt status determined on audit. The Secretary shall consult with representatives of State and local governments in providing recommendations to address this issue, including the feasibility of State maintained lists of their exempt governmental entities.

Effective date.-- The provision regarding the taxation of transmix and diesel fuel blendstocks is effective for fuel removed, sold, or used after December 31, 2004. The requirement for a Treasury study is effective on the date of enactment.

D. Nonqualified Deferred Compensation Plans

1. Treatment of nonqualified deferred compensation plans (sec. 671 of the House bill, section 671 of the Senate amendment, and new sec. 409A and secs. 6040 and 6051 of the Code)

Present Law

In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[795] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). Amounts deferred under a nonaccount balance plan that are not reasonably ascertainable are not required to be taken into account as wages subject to social security and Medicare taxes until the first date that such amounts are reasonably ascertainable. Social security and Medicare tax treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[796] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial

[795] *See, e.g.*, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[796] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[797] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi trusts

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[798] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

[797] Treas. Reg. secs. 1.451-1 and 1.451-2.

[798] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

The IRS has issued guidance setting forth model rabbi trust provisions.[799] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which attempt to allow deferred amounts to be available to individuals, while still purporting to meet the safe harbor requirements set forth by the IRS.

House Bill

Under the House bill, all amounts deferred under a nonqualified deferred compensation plan[800] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[801] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the provision.

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees[802] of publicly-traded corporations.

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[799] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

[800] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

[801] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[802] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees),

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

A participant is considered disabled if he or she (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason on any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The provision provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

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five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

The provision requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. For example, it is expected that Treasury regulations provide that, in appropriate circumstances, elections to defer incentive bonuses earned over a period of several years may be made after the beginning of the service period, as long as such elections may in no event be made later than 12 months before the earliest date on which such incentive bonus is initially payable. The Secretary may consider other factors in determining the appropriate election period, such as when the amount of the bonus payment is determinable. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the provision. Under the provision, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the provision.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the provision, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets are located outside of the United States or at the time transferred if such assets are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. It is expected that the Secretary will provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[803] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the provision.[804] Plans subject to section 457, other than governmental eligible deferred compensation plans, are subject to both the requirements of section 457 and the provision. For example, in addition to the requirements of the provision, an eligible deferred compensation plan of a tax-exempt employer would still be required to meet the applicable dollar limits under section 457.

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[803] A qualified employer plan also includes a section 501(c)(18) trust.

[804] A governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision is not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The provision requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[805]

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used inconsistent with the purposes of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

<u>Effective date</u>.–The House bill is effective for amounts deferred after June 3, 2004. The provision does not apply to amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

It is intended that amounts further deferred under a subsequent election with respect to amounts originally deferred before June 4, 2004, are subject to the requirements of the provision.

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[805] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted before June 4, 2004, may, without violating the requirements of the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after June 3, 2004, if such amounts are includible in income as earned.

Senate Amendment

The Senate amendment follows the House bill with the following modifications.

Under the Senate amendment, if the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 10-percent tax.

Under the Senate amendment, in the case of an individual who, with respect to a corporation, is subject to the requirements of section 16(a) of the Securities Act of 1934, distributions upon a change in control may not be made earlier than one year after the date of the change in control of the corporation. Such individuals include officers (as defined by section 16(a)),[806] directors, or 10-percent owners of publicly-held corporations. Under the provision, distributions made to such individuals within one year of the change in control ("applicable payments") are treated as excess parachute payments under section 280G (even if the payment would not otherwise be treated as an excess parachute payment) and therefore subject to the excise tax under section 4999. As under present law, no deduction is allowed for any amount treated as an excess parachute payment.

If, absent the provision, an applicable payment is a payment in the nature of compensation contingent on a change in control, section 280G is applied as if the provision had not been enacted (i.e., the applicable payments continue to be taken into account under section 280G). Any resulting excess parachute payment is also subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Under the provision, an applicable payment that, absent the provision, is not a payment in the nature of compensation contingent on a change in control is required to be taken into account in determining if the present value of the payments in the nature of compensation contingent on a change in control equal or exceed three times the base amount. Any resulting excess parachute payment is also subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Applicable payments do not include payments made upon death or if the participant becomes disabled. Treasury regulations shall prescribe rules to prevent a deduction from being disallowed more than once.

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

Under the Senate amendment, unforeseeable emergency also includes hardship of a beneficiary. Unforeseeable emergency is defined as severe financial hardship of the participant or beneficiary resulting from a sudden and unexpected illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. Distributions are not allowed to the extent that the hardship may be relieved by liquidation of the participant's or beneficiary's assets.

Under the Senate amendment, participants must be limited to one subsequent election.

The Senate amendment includes restrictions on investment options. Under the Senate amendment, investment options (including phantom or notional investment options) which a participant may elect under the nonqualified deferred compensation plan must be comparable to those which may be elected by participants of the qualified defined contribution plan of the employer that has the fewest investment options. It is intended that the investment options of the nonqualified deferred compensation plan may be less favorable or more limited than those of the qualified defined contribution employer plan. The Committee intends that open brokerage windows, hedge funds, and investments in which the employer guarantees a rate of return above what is commercially available are prohibited. If there is no qualified defined contribution employer plan, the investment options of the nonqualified deferred compensation plan must meet the requirements prescribed by the Secretary regarding permissible investment options. It is intended that in cases where there is no such qualified defined contribution employer plan, the Secretary issue rules limiting the available investment options.

The Senate amendment includes an exception to the provision requiring assets set aside outside of the U.S. for purposes of paying deferred compensation to be treated as property transferred in connection with the performance of services. The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements.

The Senate amendment does not apply to a plan meeting the requirements of section 457(e)(12) if the plan was in existence as of May 1, 2004, and was providing nonelective deferred compensation described in section 457(e)(12) on such date. If the plan has a material change in the class of individuals eligible to participate in the plan after May 1, 2004, the exception does not apply to compensation provided under the plan after the date of such change.

The Senate amendment does not includes an exception from the reporting requirement for deferrals that are not reasonable ascertainable.

Effective date.–The provision is effective for amounts deferred in taxable years beginning after December 31, 2004.

Not later than 90 days after the date of enactment, the Secretary is directed to issue guidance providing a limited period during which an individual participating in a nonqualified deferred compensation plan adopted on or before December 31, 2004, may, without violating the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2004, if such amounts are includible in income as earned.

Conference Agreement

In general

The conference agreement follows the House bill with the following modifications. Under the conference agreement, all amounts deferred under a nonqualified deferred compensation plan[807] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[808] and not previously included in gross income, unless certain requirements are satisfied.[809] If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.[810]

Current income inclusion, interest, and the additional tax apply only with respect to the participants with respect to whom the requirements of the provision are not met. For example, suppose a plan covering all executives of an employer (including those subject to section 16(a) of the Securities and Exchange Act of 1934) allows distributions to individuals subject to section 16(a) upon a distribution event that is not permitted under the provision. The individuals subject to section 16(a), rather than all participants of the plan, would be required to include amounts deferred in income and would be subject to interest and the 20-percent additional tax.

[807] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[808] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[809] It is intended that Treasury regulations will provide guidance regarding when an amount is deferred. It is intended that timing of an election to defer is not determinative of when the deferral is made.

[810] These consequences apply under the provision to amounts deferred after the effective date of the provision.

Permissible distributions

In general

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution.

Separation from service

In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees[811] of publicly-traded corporations.

Specified time

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Change in control

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

Unforeseeable emergency

An unforeseeable emergency is defined as a severe financial hardship to the participant: (1) resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in sec. 152(a)); (2) loss of the participant's property due to casualty; or (3) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond

[811] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

Disability

A participant is considered disabled if he or she (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (2) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

Prohibition on acceleration of distributions

As mentioned above, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, it is intended that the rule against accelerations is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump-sum payment may be permitted. It is also intended that the Secretary provide rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted.

It is intended that the Secretary will provide other, limited, exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. For example, it is anticipated that an exception could be provided if a distribution is needed in order to comply with Federal conflict of interest requirements or a court-approved settlement incident to divorce. It is intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing that withholding of an employee's share of employment taxes will be made from the employee's interest in the nonqualified deferred compensation plan. It is also intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing for a distribution to a participant to pay income taxes due upon a vesting event subject to section 457(f), provided that such amount is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under section 457(f). It is also intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing for automatic distributions of minimal interests in a deferred compensation plan upon permissible distribution events for purposes of administrative convenience. For example, a plan could provide that upon separation from service of a participant, account balances less than $10,000 will be automatically distributed (except in the case of specified employees).

Requirements with respect to elections

The provision requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations.[812] In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. It is not intended that the provision override the constructive receipt doctrine, as constructive receipt rules continue to apply. It is intended that the term "performance-based compensation" will be defined by the Secretary to include compensation to the extent that an amount is: (1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and (2) not readily ascertainable at the time of the election. For the purposes of the provision, it is intended that performance-based compensation may be required to meet certain requirements similar to those under section 162(m), but would not be required to meet all requirements under that section. For example, it is expected that the Secretary will provide that performance criteria would be considered preestablished if it is established in writing no later than 90 days after the commencement of the service period, but the requirement of determination by the compensation committee of the board of directors would not be required. It is expected that the Secretary will issue guidance providing coordination rules, as appropriate, regarding the timing of elections in the case when the fiscal year of the employer and the taxable year of the individual are different. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the provision.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the provision. It is intended that multiple payout events are permissible. For example, a participant could elect to receive 25 percent of their account balance at age 50 and the remaining 75 percent at age 60. A plan could also allow participants to elect different forms of payment for different permissible distribution events. For example, a participant could elect to receive a lump-sum distribution upon disability, but an annuity at age 65.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that

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[812] Under the provision, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible. The Secretary may issue regulations regarding elections with respect to payments under nonelective, supplemental retirement plans.

Foreign trusts

Under the provision, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

It is expected that the Secretary will provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Triggers upon financial health

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. An amount is treated as restricted even if the assets are available to satisfy the claims of general creditors. For example, the provision applies in the case of a plan that provides that upon a change in financial health, assets will be transferred to a rabbi trust.

The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. The provision is not intended to apply when assets are restricted for a reason other than change in financial health (e.g., upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status. Any subsequent increases in the value of, or any earnings with respect to, restricted assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Definition of nonqualified deferred compensation plan

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.[813] A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[814] A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan under the provision. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan. The application of the provision is not limited to arrangements between an employer and employee.

For purposes of the provision, it is not intended that the term "nonqualified deferred compensation plan" include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future. The provision is not intended to change the tax treatment of incentive stock options meeting the

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[813] The provision does not apply to a plan meeting the requirements of section 457(e)(12) if the plan was in existence as of May 1, 2004, was providing nonelective deferred compensation described in section 457(e)(12) on such date, and is established or maintained by an organization incorporated on July 2, 1974. If the plan has a material change in the class of individuals eligible to participate in the plan after May 1, 2004, the provision applies to compensation provided under the plan after the date of such change.

[814] A qualified employer plan also includes a section 501(c)(18) trust.

requirements of 422 or options granted under an employee stock purchase plan meeting the requirements of section 423.

It is intended that the provision does not apply to annual bonuses or other annual compensation amounts paid within 2 ½ months after the close of the taxable year in which the relevant services required for payment have been performed.

Other rules

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision is not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

Treasury regulations

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture. It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used in a manner inconsistent with the purposes of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction. The Secretary may also address in regulations issues relating to stock appreciation rights.

Aggregation rules

Under the provision, except as provided by the Secretary, employer aggregation rules apply. It is intended that the Secretary issue guidance providing aggregation rules as are necessary to carry out the purposes of the provision. For example, it is intended that aggregation rules would apply in the case of separation from service so that the separation from service from one entity within a controlled group, but continued service for another entity within the group, would not be a permissible distribution event. It is also intended that aggregation rules would not apply in the case of change in control so that the change in control of one member of a controlled group would not be a permissible distribution event for participants of a deferred compensation plan of another member of the group.

Reporting requirements

Amounts required to be included in income under the provision are subject to reporting and Federal income tax withholding requirements. Amounts required to be includible in income are required to be reported on an individual's Form W-2 (or Form 1099) for the year includible in income.

The provision also requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year. It is expected that annual reporting of annual amounts deferred will provide the IRS greater information regarding such arrangements for enforcement purposes. It is intended that the information reported would provide an indication of what arrangements should be examined and challenged. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[815]

Effective date

The provision is effective for amounts deferred in taxable years beginning after December 31, 2004. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

Amounts deferred in taxable years beginning before January 1, 2005, are subject to the provision if the plan under which the deferral is made is materially modified after October 3, 2004. The addition of any benefit, right or feature is a material modification. The exercise or reduction of an existing benefit, right, or feature is not a material modification. For example, an amendment to a plan on November 1, 2004, to add a provision that distributions may be allowed upon request if participants are required to forfeit 10 percent of the amount of the distribution (i.e., a "haircut") would be a material modification to the plan so that the rules of the provision would apply to the plan. Similarly, accelerating vesting under a plan after October 3, 2004, would be a material modification. A change in the plan administrator would not be a material modification. As another example, amending a plan to remove a distribution provision (e.g., to remove a "haircut") would not be considered a material modification.

Operating under the terms of a deferred compensation arrangement that complies with current law and is not materially modified after October 3, 2004, with respect to amounts deferred before January 1, 2005, is permissible, as such amounts would not be subject to the requirements of the provision. For example, subsequent deferrals with respect to amounts deferred before January 1, 2005, under a plan that is not materially modified after October 3,

[815] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

2004, would be subject to present law and would not be subject to the provision.[816] No inference is intended that all deferrals before the effective date are permissible under present law. It is expected that the IRS will challenge pre-effective date deferral arrangements that do not comply with present law.

For purposes of the effective date, an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date. To the extent there is no material modification after October 3, 2004, present law applies with respect to vested rights.

No later than 60 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation plan adopted before December 31, 2004, may, without violating the requirements of the provision relating to distributions, accelerations, and elections be amended (1) to provide that a participant may terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if such amounts are includible in income of the participant as earned, or if later, when not subject to a substantial risk of forfeiture, and (2) to conform with the provision with respect to amounts deferred after December 31, 2004. It is expected that the Secretary may provide exceptions to certain requirements of the provision during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the provision. Moreover, it is expected that the Secretary will provide a reasonable time, during the transition period but after the issuance of guidance, for plans to be amended and approved by the appropriate parties in accordance with this provision.

2. Denial of deferral of certain stock option and restricted stock gains (sec. 672 of the Senate amendment and sec. 83 of the Code)

Present Law

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient

[816] There is no inference that all subsequent deferral elections under plans that are not materially modified are permissible under present law.

exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

Other forms of stock-based compensation are also subject to the rules of section 83.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other compensation based on employer securities (including employer securities) cannot be deferred by exchanging such amounts for a right to receive a future payment. Except as provided by the Secretary, if a taxpayer exchanges (1) an option to purchase employer securities, (2) employer securities, or (3) any other property based on employer securities for a right to receive future payments, an amount equal to the present value of such right (or such other amount as the Secretary specifies) is required to be included in gross income for the taxable year of the exchange. The provision applies even if the future right to payment is treated as an unfunded and unsecured promise to pay. The provision applies when there is in substance an exchange, even if the transaction is not formally structured as an exchange.

The provision is not intended to imply that such practices result in permissive deferral of income under present law.

<u>Effective date</u>.–The Senate amendment applies to exchanges after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment.

E. Other Revenue Provisions

1. Permit private sector debt collection companies to collect tax debts (sec. 681 of the House bill, sec. 487 of the Senate amendment, and new sec. 6306 of the Code)

Present Law

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes.[817] The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[818] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot. The pilot program results were disappointing because "IRS' efforts to design and implement the private debt collection pilot program were hindered by limitations that affected the program's results." The limitations included the scope of work permitted to the private debt collection companies, the number and type of cases referred to the private debt collection companies, and the ability of IRS' computer systems to identify, select, and transmit collection cases to the private debt collectors.

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[819] GAO recently reviewed IRS' planning and preparation for the use of private debt collection companies.[820] GAO identified five broad factors critical to the success of using private debt collection companies to collect taxes. GAO concluded: "If Congress does authorize PCA[821] use, IRS's planning and preparations to address the critical success factors for PCA contracting provide

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[817] Sec. 7801(a).

[818] GAO/GGD-97-129R *Issues Affecting IRS' Collection Pilot* (July 18, 1997).

[819] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.

[820] GAO-04-492 *Tax Debt Collection: IRS Is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources* (May 2004).

[821] Private collection agencies.

greater assurance that the PCA program is headed in the right direction to meet its goals and achieve desired results. Nevertheless, much work and many challenges remain in addressing the critical success factors and helping to maximize the likelihood that a PCA program would be successful."[822]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[823] That provision does not apply to the collection of debts under the Internal Revenue Code.[824]

The President's fiscal year 2004 and 2005 budget proposals proposed the use of private debt collection companies to collect Federal tax debts.

House Bill

The bill permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type[825] and to arrange payment of those taxes by the taxpayers. There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability. An assessment is the formal recording of the taxpayer's tax liability that fixes the amount payable. An assessment must be made before the IRS is permitted to commence enforcement actions to collect the amount payable. In general, an assessment is made at the conclusion of all examination and appeals processes within the IRS.[826]

Several steps are involved in the deployment of private debt collection companies. First, the private debt collection company contacts the taxpayer by letter.[827] If the taxpayer's last

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[822] Page 19 of the May 2004 GAO report.

[823] 31 U.S.C. sec. 3718.

[824] 31 U.S.C. sec. 3718(f).

[825] The provision generally applies to any type of tax imposed under the Internal Revenue Code. It is anticipated that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[826] An amount of tax reported as due on the taxpayer's tax return is considered to be self-assessed. If the IRS determines that the assessment or collection of tax will be jeopardized by delay, it has the authority to assess the amount immediately (sec. 6861), subject to several procedural safeguards.

[827] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to section 6103 is necessary to implement the provision. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least

known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[828] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as five years. If the taxpayer is unable to pay the outstanding tax liability in full over a five-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The bill specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees are also made statutorily applicable to employees of private sector debt collection companies. Third, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS. In addition, it is intended that the IRS require the private sector debt collection companies to inform every taxpayer they contact of the availability of assistance from the Taxpayer Advocate.

The bill creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The bill prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[829]

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except that it: (1) sunsets the provision in five years; (2) provides that, if the taxpayer cannot pay in full immediately, the private debt collection company may offer the taxpayer an installment agreement providing for full payment of the taxes over three years; (3) provides that up to 25 percent of amount collected may be used for IRS collection enforcement activities; (4) and requires Treasury to provide a biennial report to Congress.

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amount of information possible to contractors consistent with the effective operation of the provision.

[828] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

[829] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.

Conference Agreement

The conference agreement follows the House bill, with the addition of two provisions from the Senate amendment: (1) the conference agreement provides that up to 25 percent of amount collected may be used for IRS collection enforcement activities; and (2) the conference agreement requires Treasury to provide a biennial report to Congress. The conferees expect that, consistent with best management practices and sound tax administration principles, the Secretary will utilize this new debt collection provision to the maximum extent feasible.

The conferees expect that activities conducted by any person under a qualified tax collection contract will be in compliance with the Fair Debt Collection Practices Act, as required by new section 6306(e) of the Code. Accordingly, the conferees anticipate that the Secretary will not impose requirements that would violate this provision of the Code. The conferees believe that this new debt collection provision will protect both taxpayers' rights and the confidentiality of tax information.

2. Modify charitable contribution rules for donations of patents and other intellectual property (sec. 682 of the House bill, sec. 494 of the Senate amendment, and secs. 170 and 6050L of the Code)

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[830] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets, in which case the charitable deduction for such copyrights generally is limited to the taxpayer's basis.[831]

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[830] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[831] *See* sec. 1221(a)(3), 1231(b)(1)(C).

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[832] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[833] In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[834]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[835] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[836] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[837]

[832] Sec. 170(f)(3).

[833] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

[834] Sec. 170(f)(8).

[835] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[836] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[837] Treas. Reg. sec. 1.170A-13(c)(3).

House Bill

The provision provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property. For this purpose, "qualified donee income" includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income received or accrued by the charitable donee that properly is allocable to the contributed property to the applicable taxable year of the donor, determined as follows:

Taxable Year of Donor	**Deduction Permitted for Such Taxable Year**
1st year ending on or after contribution	100 percent of qualified donee income
2nd year ending on or after contribution	100 percent of qualified donee income
3rd year ending on or after contribution	90 percent of qualified donee income
4th year ending on or after contribution	80 percent of qualified donee income
5th year ending on or after contribution	70 percent of qualified donee income
6th year ending on or after contribution	60 percent of qualified donee income
7th year ending on or after contribution	50 percent of qualified donee income
8th year ending on or after contribution	40 percent of qualified donee income
9th year ending on or after contribution	30 percent of qualified donee income
10th year ending on or after contribution	20 percent of qualified donee income
11th year ending on or after contribution	10 percent of qualified donee income
12th year ending on or after contribution	10 percent of qualified donee income
Taxable years thereafter	No deduction permitted

An additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated pursuant to the sliding-scale exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property.

No charitable deduction is permitted with respect to any revenues or income received or accrued by the charitable donee after the expiration of the legal life of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer is required to inform the donee at the time of the contribution that the taxpayer intends to treat the contribution as a contribution subject to the additional charitable deduction provisions of the provision. In addition, the taxpayer must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the charity's taxable year.[838] The donee is required to file an annual information return that reports the qualified donee income and other specified information relating to the contribution. In instances where the donor's taxable year differs from the donee's taxable year, the donor bases its additional charitable deduction on the qualified donee income of the charitable donee properly allocable to the donee's taxable year that ends within the donor's taxable year.

Under the provision, additional charitable deductions are not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation or certain other private foundations described in section 170(b)(1)(E)).

Under the provision, the Secretary may prescribe regulations or other guidance to carry out the purposes of the provision, including providing for the determination of amounts to be treated as qualified donee income in certain cases where the donee uses the donated property to further its exempt activities or functions, or as may be necessary or appropriate to prevent the avoidance of the purposes of the provision.

Effective date.–Effective for contributions made after June 3, 2004.

Senate Amendment

The Senate amendment is similar to the House bill, except that the taxpayer's initial deduction is equal to: the lesser of the taxpayer's basis in the contributed property or the fair market value of the property (as in the House bill) or, if greater, the lesser of 5 percent of the fair market value of the contributed property or $1 million. Additional charitable deductions are available as in the House bill, except that such additional deductions are not required to be offset by the initial deductible amount.

The Senate amendment imposes a processing fee (credited to the Exempt Organizations unit with the IRS) equal to 1 percent of the claimed deductible amount for contributions of applicable intellectual property.

With respect to applicable intellectual property contributions, the Senate amendment increases the present law thresholds that trigger application of penalties for substantial and gross valuation misstatements. The substantial misstatement penalty applies if the taxpayer's claimed

[838] The net income taken into account by the taxpayer may not exceed the amount of qualified donee income reported by the donee to the taxpayer and the IRS under the provision's substantiation and reporting requirements.

value exceeds the correct amount by 50 percent or more; the gross misstatement penalty applies if the taxpayer's claimed value exceeds the correct amount by 100 percent or more.

The Senate amendment requires that the Secretary shall prescribe guidance on appraisal standards for charitable contributions of intellectual property.

Effective date.–Contributions after the date of enactment.

Conference Agreement

The conference agreement follows the House bill.

Effective date.–Effective for contributions made after June 3, 2004.

3. Require increased reporting for noncash charitable contributions (sec. 683 of the House bill and sec. 170 of the Code)

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[839] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Taxpayers are required to obtain a qualified appraisal for donated property (other than money and publicly traded securities) with a value of more than $5,000.[840] Corporations (other

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[839] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[840] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and taxpayer identification number of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

than a closely-held corporation, a personal service corporation, or an S corporation) are not required to obtain a qualified appraisal. Taxpayers are not required to attach a qualified appraisal to the taxpayer's return, except in the case of contributed art-work valued at more than $20,000. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[841] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[842]

House Bill

The provision requires increased donor reporting for certain charitable contributions of property other than cash, inventory, or publicly traded securities. The provision extends to all C corporations the present law requirement, applicable to an individual, closely-held corporation, personal service corporation, partnership, or S corporation, that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. The provision also provides that if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor's tax return. For purposes of the dollar thresholds under the provision, property and all similar items of property donated to one or more donees are treated as one property.

The provision provides that a donor that fails to substantiate a charitable contribution of property, as required by the Secretary, is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. The denial of the deduction does not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

The provision provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision, including regulations that may provide that some or all of the requirements of the provision do not apply in appropriate cases.

Effective date.–Effective for contributions made after June 3, 2004.

Senate Amendment

No provision.

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[841] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[842] Treas. Reg. sec. 1.170A-13(c)(3).

Conference Agreement

The conference agreement follows the House bill, except that appraisals are not required for charitable contributions of certain vehicles that are sold by the donee organization without a significant intervening use or material improvement of the vehicle by such organization, and for which the organization provides an acknowledgement to the donor containing a certification that the vehicle was sold in an arm's length transaction between unrelated parties, and providing the gross sales proceeds from the sale, and a statement that the donor's deductible amount may not exceed the amount of such gross proceeds.

Effective date.–Effective for contributions made after June 3, 2004.

4. Limit deduction for charitable contributions of vehicles (sec. 684 of the House bill, sec. 731 of the Senate amendment, and new sec. 6720 and sec. 170 of the Code)

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[843] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to determine the deductible amount by subtracting any gain from fair market value, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

A taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer's basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as boats.

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[843] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[844] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[845] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[846]

Appraisal fees paid by an individual to determine the fair market value of donated property are deductible as miscellaneous expenses subject to the 2 percent of adjusted gross income limit.[847]

House Bill

The provision allows a charitable deduction for contributions of vehicles for which the taxpayer claims a deduction of more than $250 only if the taxpayer obtains a qualified appraisal of the vehicle. The provision applies to automobiles and other types of motor vehicles manufactured primarily for use on public streets, roads, and highways; boats; and aircraft. The provision does not affect contributions of inventory property. The definition of qualified

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[844] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[845] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[846] Treas. Reg. sec. 1.170A-13(c)(3).

[847] Rev. Rul. 67-461, 1967-2 C.B. 125.

appraisal generally follows the definition contained in present law, subject to additional regulations or guidance provided by the Secretary. The qualified appraisal of a donated vehicle must be obtained by the taxpayer by the time the contribution is made. Under the provision, the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of the provision.

Effective date.–Effective for contributions made after June 3, 2004.

Senate Amendment

Under the Senate amendment, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction shall not exceed the gross proceeds received from the sale.

The proposal imposes new substantiation requirements for contributions of vehicles for which the claimed value exceeds $500 (excluding inventory). A deduction is not allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement by the donee. The acknowledgement must contain the name and taxpayer identification number of the donor and the vehicle identification number (or similar number) of the vehicle. In addition, if the donee sells the vehicle without performing a significant intervening use or material improvement of such vehicle, the acknowledgement must provide a certification that the vehicle was sold in an arm's length transaction between unrelated parties, and state the gross proceeds from the sale and that the deductible amount may not exceed such gross proceeds. In all other cases, the acknowledgement must contain a certification of the intended use or material improvement of the vehicle and the intended duration of such use, and a certification that the vehicle will not be transferred in exchange for money, other property, or services before completion of such use or improvement. The donee must notify the Secretary of the information contained in an acknowledgement, in a time and manner provided by the Secretary. An acknowledgement is considered contemporaneous if provided within 30 days of sale of a vehicle that is not significantly improved or materially used by the donee, or, in all other cases, within 30 days of the contribution.

A penalty applies if a donee organization knowingly furnishes a false or fraudulent acknowledgement, or knowingly fails to furnish an acknowledgement in the manner, at the time, and showing the required information. In the case of an acknowledgement provided within 30 days of sale of a vehicle which is not significantly used or materially improved by the donee, the penalty is the greater of the value of the tax benefit to the donor or the gross proceeds from the sale of the vehicle. For all other acknowledgements, the penalty is the greater of the value of the tax benefit to the donor or the claimed value of the vehicle or $5,000.

The Senate amendment provides that the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of the proposal.

Effective date.–Contributions after June 30, 2004.

Conference Agreement

The conference agreement follows the Senate amendment, except that the penalty on the donee organization for knowingly furnishing a false or fraudulent acknowledgement is determined differently. With respect to a qualified vehicle sold without a significant intervening use or material improvement, the penalty is the greater of the gross proceeds from the sale of the vehicle or the product of the highest rate of tax specified in section 1 and the sales price stated on the acknowledgement. For all other acknowledgements, the penalty is the greater of $5,000 or the product of the highest rate of tax specified in section 1 and the claimed value of the vehicle.

The conference agreement also provides that the Secretary may prescribe regulations or other guidance that exempts sales of vehicles that are in direct furtherance of the donee's charitable purposes from the requirement that the donor may not deduct an amount in excess of the gross proceeds from the sale, and the requirement that the donee certify that the vehicle will not be transferred in exchange for money, other property, or services before completion of a significant use or material improvement by the donee. The conferees intend that such guidance may be appropriate, for example, if an organization directly furthers its charitable purposes by selling automobiles to needy persons at a price significantly below fair market value.

The conferees intend that in providing guidance on the provision, the Secretary shall strictly construe the requirement of significant use or material improvement. To meet the significant use test, an organization must actually use the vehicle to substantially further the organization's regularly conducted activities and the use must be significant. A donee will not be considered to significantly use a qualified vehicle if, under the facts and circumstances, the use is incidental or not intended at the time of the contribution. Whether a use is significant also depends on the frequency and duration of use. With respect to the material improvement test, the conferees intend that a material improvement would include major repairs to a vehicle, or other improvements to the vehicle that improve the condition of the vehicle in a manner that significantly increases the vehicle's value. Cleaning the vehicle, minor repairs, and routine maintenance are not considered a material improvement.

<u>Example 1</u>. As part of its regularly conducted activities, an organization delivers meals to needy individuals. The use requirement would be met if the organization actually used a donated qualified vehicle to deliver food to the needy. Use of the vehicle to deliver meals substantially furthers a regularly conducted activity of the organization. However, the use also must be significant, which depends on the nature, extent, and frequency of the use. If the organization used the vehicle only once or a few times to deliver meals, the use would not be considered significant. If the organization used the vehicle to deliver meals every day for one year the use would be considered significant. If the organization drove the vehicle 10,000 miles while delivering meals, such use likely would be considered significant. However, use of a vehicle in such an activity for one week or for several hundreds of miles generally would not be considered a significant use.

<u>Example 2</u>. An organization uses a donated qualified vehicle to transport its volunteers. The use would not be significant merely because a volunteer used the vehicle over a brief period of time to drive to or from the organization's premises. On the other hand, if at the time the organization accepts the contribution of a qualified vehicle, the organization intends to use the

vehicle as a regular and ongoing means of transport for volunteers of the organization, and such vehicle is so used, then the significant use test likely would be met.

Example 3. The following example is a general illustration of the provision. A taxpayer makes a charitable contribution of a used automobile in good running condition and that needs no immediate repairs to a charitable organization that operates an elder care facility. The donee organization accepts the vehicle and immediately provides the donor a written acknowledgment containing the name and TIN of the donor, the vehicle identification number, a certification that the donee intends to retain the vehicle for a year or longer to transport the facility's residents to community and social events and deliver meals to the needy, and a certification that the vehicle will not be transferred in exchange for money, other property, or services before completion of such use by the organization. A few days after receiving the vehicle, the donee organization commences to use the vehicle three times a week to transport some of its residents to various community events, and twice a week to deliver food to needy individuals. The organization continues to regularly use the vehicle for these purposes for approximately one year and then sells the vehicle. Under the provision, the donee's use of the vehicle constitutes a significant intervening use prior to the sale by the organization, and the donor's deduction is not limited to the gross proceeds received by the organization.

Effective date.–Effective for contributions made after December 31, 2004.

5. Extend the present-law intangible amortization provisions to acquisitions of sports franchises (sec. 685 of the House bill, sec. 471 of the Senate amendment, and sec. 197 of the Code)

Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[848] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[849] However, other special rules apply to certain of these intangible assets.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a

[848] Sec. 197.

[849] Sec. 197(e)(6).

franchise to conduct a sports enterprise is effected through a partnership.[850] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

In general, section 1245 provides that gain from the sale of certain property is treated as ordinary income to the extent depreciation or amortization was allowed on such property. Section 1245(a)(4) provides special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply in the case of the sale, exchange, or other disposition of a sports franchise. Under the special recapture rules, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise.

House Bill

The House bill extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with the acquisition of such a franchise (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises. The provision also repeals the special rules under section 1245(a)(4) and makes other conforming changes.

Effective date.–The House bill is effective for property acquired after the date of enactment. The amendment to section 1245(a)(4) applies to franchises acquired after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

6. Increase continuous levy for certain federal payments (sec. 686 of the House bill, sec. 734 of the Senate amendment, and sec. 6331(h) of the Code)

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[851] by the IRS, the IRS may then collect the tax by levy upon all property and

[850] *P.D.B. Sports, Ltd. v. Comm.*, 109 T.C. 423 (1997).

[851] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be

rights to property belonging to the person,[852] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[853]

A continuous levy is applicable to specified Federal payments.[854] This includes any Federal payment for which eligibility is not based on the income and/or assets of a payee. Thus, a Federal payment to a vendor of goods or services to the government is subject to continuous levy. This continuous levy attaches up to 15 percent of any specified payment due the taxpayer.

House Bill

The bill permits a levy of up to 100 percent of a Federal payment to a vendor of goods or services to the Federal Government.

Effective date.–Date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

7. Modification of straddle rules (sec. 687 of the House bill, sec. 464 of the Senate amendment, and sec. 1092 of the Code)

Present Law

Straddle rules

In general

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the

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mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[852] Code sec. 6331.

[853] Code secs. 6335-6343.

[854] Code sec. 6331(h).

extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[855] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

Positions in stock

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Although the straddle rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules generally do not apply if the option is a "qualified covered call option" written by the taxpayer.[856] In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

The stock exception from the straddle rules has been largely curtailed by statutory amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[857]

Unbalanced straddles

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[858] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45 per share, the taxpayer

[855] Sec. 1092.

[856] However, if the option written by the taxpayer is a qualified covered call option that is in-the-money, then (1) any loss with respect to such option is treated as long-term capital loss if, at the time such loss is realized, gain on the sale or exchange of the offsetting stock held by the taxpayer would be treated as long-term capital gain, and (2) the holding period of such stock does not include any period during which the taxpayer is the grantor of the option (sec. 1092(f)).

[857] Prop. Treas. Reg. sec. 1.1092(d)-2(c).

[858] Sec. 1092(c)(2)(B).

pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[859] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[860] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock (i.e., the number of shares specified in the costless collar) because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) and (3) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

<u>Holding period for dividends-received deduction</u>

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends-received deduction for dividends received on that instrument.[861] The dividends-received deduction is allowed to a

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[859] Priv. Ltr. Rul. 199925044 (Feb. 3, 1999).

[860] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

[861] Sec. 243. The amount of the deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns 20 percent or more of the stock, the deduction is increased to 80 percent. If the recipient

corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day holding period for certain dividends on preferred stock).[862] The holding period must be satisfied for each dividend over a period that is immediately before and immediately after the taxpayer becomes entitled to receive the dividend. The 46- or 91-day holding period generally does not include any time during which the shareholder is protected (other than by writing a qualified covered call) from the risk of loss that is otherwise inherent in the ownership of any equity interest.[863]

House Bill

Straddle rules

The House bill modifies the straddle rules in three respects: (1) permits taxpayers to identify offsetting positions of a straddle; (2) provides a special rule to clarify the present-law treatment of certain physically settled positions of a straddle; and (3) repeals the stock exception from the straddle rules.

Identified straddles

Under the House bill, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle.[864] If there is a loss with respect to any identified position that is part of an identified straddle, the general straddle loss deferral rules do not apply to such loss. Instead, the basis of each of the identified positions that offset the loss position in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain (if any) with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all positions that offset the loss position in the identified straddle.[865] Any loss with respect to an identified position that is part of an identified straddle cannot otherwise be taken into account by the taxpayer or any other person to the extent that the

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owns 80 percent or more of the stock, the deduction is further increased to 100 percent for qualifying dividends.

[862] Sec. 246(c).

[863] Sec. 246(c)(4).

[864] However, to the extent provided by Treasury regulations, taxpayers are not permitted to identify offsetting positions of a straddle if the fair market value of the straddle position already held by the taxpayer at the creation of the straddle is less than its adjusted basis in the hands of the taxpayer.

[865] For this purpose, “unrecognized gain” is the excess of the fair market value of an identified position that is part of an identified straddle at the time the taxpayer incurs a loss with respect to another identified position in the identified straddle, over the fair market value of such position when the taxpayer identified the position as a position in the identified straddle.

loss increases the basis of any identified positions that offset the loss position in the identified straddle.

In addition, the provision provides the Secretary authority to issue regulations that would specify (1) the proper methods for clearly identifying a straddle as an identified straddle (and identifying positions as positions in an identified straddle), (2) the application of the identified straddle rules for a taxpayer that fails to properly identify the positions of an identified straddle,[866] and (3) provide an ordering rule for dispositions of less than an entire position that is part of an identified straddle.

Physically settled straddle positions

The House bill also clarifies the present-law straddle rules with respect to taxpayers that settle a position that is part of a straddle by delivering property to which the position relates. Specifically, the provision clarifies that the present-law straddle loss deferral rules treat as a two-step transaction the physical settlement of a straddle position that, if terminated, would result in the realization of a loss. With respect to the physical settlement of such a position, the taxpayer is treated as having terminated the position for its fair market value immediately before the settlement. The taxpayer then is treated as having sold at fair market value the property used to physically settle the position.

Stock exception repeal

The House bill also eliminates the exception from the straddle rules for stock (other than the exception relating to qualified covered call options). Thus, offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle.[867]

Dividends-received deduction holding period

The House bill also modifies the required 46- or 91-day holding period for the dividends-received deduction by providing that the holding period does not include any time during which the shareholder is protected from the risk of loss otherwise inherent in the ownership of any

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[866] For example, although the provision does not require taxpayers to identify any positions of a straddle as an identified straddle, it may be necessary to provide rules requiring all balanced offsetting positions to be included in an identified straddle if a taxpayer elects to identify any of the offsetting positions as an identified straddle.

[867] It is intended that Treasury regulations defining substantially similar or related property for this purpose will continue to apply subsequent to repeal of the stock exception and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock. *See* Prop. Treas. Reg. sec. 1.1092(d)-2(b). However, the general straddles rules regarding substantial diminution in risk of loss will continue to apply to stock of corporations formed or availed of to take positions in personal property that offset positions taken by the shareholder.

equity interest if the shareholder obtains such protection by writing an in-the-money call option on the dividend-paying stock.

Effective date

The House bill provision is effective for positions established on or after the date of enactment that substantially diminish the risk of loss from holding offsetting positions (regardless of when such offsetting position was established).

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment also limits the present-law qualified covered call option exception to options traded on a national securities exchange that is registered with the Securities and Exchange Commission.

Conference Agreement

The conference agreement follows the House bill.

8. Add vaccines against Hepatitis A to the list of taxable vaccines (sec. 688 of the House bill, sec. 491 of the Senate amendment, and sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[868] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

House Bill

The House bill adds any vaccine against hepatitis A to the list of taxable vaccines.

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[868] Sec. 4131

Effective date.–The provision is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

Senate Amendment

The Senate amendment adds any vaccine against hepatitis A to the list of taxable vaccines. The Senate amendment also makes a conforming amendment to the trust fund expenditure purposes.

Effective date.–The provision is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

Conference Agreement

The conference agreement includes the House bill provision.

9. Add vaccines against influenza to the list of taxable vaccines (sec. 689 of the House bill, sec. 732 of the Senate amendment, and sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[869] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

House Bill

The House bill adds any trivalent vaccine against influenza to the list of taxable vaccines.

Effective date.–The provision is effective for vaccines sold or used beginning on the later of the first day of the first month beginning more than four weeks after the date of enactment or the date on which the Secretary of Health and Human Services lists any such vaccine for purpose

[869] Sec. 4131

of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

Senate Amendment

The Senate amendment is identical to the House bill.

Conference Agreement

The conference agreement includes the provision of the House bill and the Senate amendment.

10. Extension of IRS user fees (sec. 690 of the House bill, sec. 482 of the Senate amendment, and sec. 7528 of the Code)

Present Law

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[870] These user fees are authorized by statute through December 31, 2004.

House Bill

The House bill extends the statutory authorization for these user fees through September 30, 2014.

Effective date.–Requests made after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, except that it extends the statutory authorization for these user fees through September 30, 2013.

Conference Agreement

The conference agreement follows the House bill.

11. Extension of Customs user fees (Sec. 691 of the House bill and sec. 485 of the Senate amendment)

Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA")[871] authorized the Secretary of the Treasury to collect certain service fees. Section

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[870] Sec. 7528.

[871] Pub.L. No. 99-272.

412 of the Homeland Security Act of 2002[872] authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. No. 108-121, which extended authorization for the collection of these fees through March 1, 2005.[873]

House Bill

The House bill extends the passenger and conveyance processing fees and the merchandise processing fees authorized under COBRA through September 30, 2014. For fiscal years after September 30, 2005, the Secretary is to charge fees in amounts that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The House bill also includes a sense of the Congress regarding the extent to which fees are related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The House bill further provides that the Secretary conduct a study of all the fees collected by the Department of Homeland Security.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

The Senate amendment extends the fees authorized under the COBRA through September 30, 2013.

Conference Agreement

The conference agreement follows the House bill provision.

12. Prohibition on nonrecognition of gain through complete liquidation of holding company (sec. 452 of the Senate amendment and sec. 332 of the Code)

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

[872] Pub.L No. 107-296.

[873] Sec. 201, 117 Stat. 1335.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

House Bill

No provision.

Senate Amendment

The provision treats as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

Effective date.–The provision is effective for distributions occurring on or after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

13. Effectively connected income to include certain foreign source income (sec. 454 of the Senate amendment and sec. 864 of the Code)

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[874] Foreign persons also are subject to a 30-percent gross-basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[875] The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a U.S. trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income (sometimes referred to as the "force of attraction rule").

In general, foreign-source income is not treated as U.S.-effectively connected income.[876] However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories described below.[877] For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.[878]

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[874] Secs. 871(b) and 882.

[875] Sec. 864(c).

[876] Sec. 864(c)(4).

[877] Sec. 864(c)(4)(B).

[878] Sec. 864(c)(5).

The first category consists of rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trademarks, trade brands, franchises, or other similar intangible properties derived in the active conduct of the U.S. trade or business.[879] The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.[880] Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock.[881] The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business.[882] Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale or exchange.

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties, and personal services income.[883] For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules.[884] In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected with a U.S. trade or business.[885] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient

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[879] Sec. 864(c)(4)(B)(i).

[880] Sec. 864(c)(4)(B)(ii).

[881] Sec. 864(c)(4)(D)(i).

[882] Sec. 864(c)(4)(B)(iii).

[883] Secs. 861 - 865.

[884] See *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982).

[885] Treas. Reg. sec. 1.864-5(b)(2)(ii).

of the income, but is treated as U.S.-source effectively connected income if it arises from the conduct of a United States trade or business.[886]

House Bill

No provision.

Senate Amendment

Under the provision, each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents are treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

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

Conference Agreement

The conference agreement follows the Senate amendment.

14. Recapture of overall foreign losses on sale of controlled foreign corporation stock (sec. 455 of the Senate amendment and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to a portion of the taxpayer's U.S. tax which portion is calculated by multiplying the taxpayer's total U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) and the denominator of which is the taxpayer's worldwide taxable income for the year.[887] Separate limitations are applied to specific categories of income.

[886] Treas. Reg. sec. 1.863-7(b)(3).

[887] Sec. 904(a).

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation.[888] Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income.[889] The amount resourced as U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured.[890] In this regard, dispositions of trade or business property used predominantly outside the United States are treated as resulting in the recognition of foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such income would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[891]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income).[892] Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only

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[888] Sec. 904(f).

[889] Sec. 904(f)(1).

[890] Sec. 904(f)(3).

[891] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Sec. 367(a)(3)(C).

[892] Sec. 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock, for purposes of the interest apportionment.

House Bill

No provision.

Senate Amendment

Under the provision, the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets applies to the disposition of stock in a controlled foreign corporation controlled by the taxpayer. Thus, a disposition of controlled foreign corporation stock by a controlling shareholder results in the recognition of foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income is resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Although the provision generally extends to all dispositions of such stock, regardless of whether gain or loss is recognized on the transfer, exceptions are made for certain internal restructurings. Contributions to corporations or partnerships under sections 351 and 721, respectively, and certain stock and asset reorganizations do not trigger recapture of overall foreign losses, provided that the transferor's underlying indirect interest in the disposed controlled foreign corporation does not change. However, any gain recognized in connection with a transaction meeting any of these exceptions, such as boot, triggers recapture of overall foreign losses to the extent of such gain.

Effective date.–The provision applies to dispositions after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with modifications. Under the provision as modified, a disposition of controlled foreign corporation stock in a transaction in which the taxpayer or a member of its consolidated group acquires the assets of the controlled foreign corporation in a liquidation under section 332 or a reorganization does not trigger the recapture of overall foreign losses. Any gain recognized in connection with a transaction meeting this exception triggers recapture of overall foreign losses to the extent of such gain.

15. Application of earnings-stripping rules to partnerships and S corporations (sec. 462 of the Senate amendment and sec. 163 of the Code)

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[893] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

The present-law earnings stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as debt of the corporate partner for purposes of applying the earnings stripping limitation to its own interest payments.[894] In addition, interest paid or accrued by a partnership is treated as interest expense of a corporate partner, with the result that a deduction for the interest expense may be disallowed if that expense would be disallowed under the earnings stripping rules if paid by the corporate partner itself.[895] The proposed regulations also provide that the earnings stripping rules do not apply to subchapter S corporations.[896] Thus, under present law and the proposed regulations, a partnership or S corporation generally is allowed a deduction for interest paid or accrued on indebtedness that it issues that otherwise would be disallowed under the earnings stripping rules in the case of a subchapter C corporation.

House Bill

No provision.

Senate Amendment

The Senate amendment incorporates a rule attributing partnership debt to a corporate partner for purposes of applying the earnings stripping rules to the corporation.[897]

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[893] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

[894] Prop. Treas. reg. sec. 1.163(j)-3(b)(3).

[895] Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[896] Prop. Treas. reg. sec. 1.163(j)-1(a)(i).

[897] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

Effective date.--The Senate amendment provision generally is effective for taxable years beginning on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

16. Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest (sec. 463 of the Senate amendment and sec. 108 of the Code)

Present Law

Under present law, a corporation that transfers shares of its stock in satisfaction of its debt must recognize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock.[898] Prior to enactment of this present-law provision in 1993, case law provided that a corporation did not recognize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of debt (referred to as the "stock-for-debt exception").[899]

When cancellation of indebtedness income is realized by a partnership, it generally is allocated among the partners in accordance with the partnership agreement, provided the allocations under the agreement have substantial economic effect. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations.[900] The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

In the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly requires the partnership to realize cancellation of indebtedness income. Thus, it is unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt

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[898] Sec. 108(e)(8).

[899] *E.g.*, *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *nonacq.* 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.* 1943 C.B. 1.

[900] Sec. 108(a).

exception. It also is unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[901]

House Bill

No provision.

Senate Amendment

The Senate amendment provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The Senate amendment applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the Senate amendment is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the Senate amendment, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Effective date.–The Senate amendment is effective for cancellations of indebtedness occurring on or after the date of enactment.

Conference Agreement

The conference agreement includes the Senate amendment.

17. Denial of installment sale treatment for all readily tradable debt (Sec. 465 of the Senate amendment and sec. 453 of the Code)

Present Law

Under present law, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[902] However, the installment method is not available if the taxpayer sells property in exchange for a

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[901] *See*, *e.g.*, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934); *American Seating Co. v. Commissioner*, 14 B.T.A. 328, *aff'd in part and rev'd in part*, 50 F.2d 681 (7th Cir. 1931); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940); Rev. Rul. 91-31, 1991-1 C.B. 19.

[902] Sec. 453.

readily tradable evidence of indebtedness that is issued by a corporation or a government or political subdivision.[903]

No similar provision under present law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

House Bill

No provision.

Senate Amendment

The Senate amendment denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable under present-law rules, regardless of the nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

Effective date.–The Senate amendment provision is effective for sales occurring on or after date of enactment.

Conference Agreement

The conference agreement includes the Senate amendment.

18. Modify treatment of transfers to creditors in divisive reorganizations (sec. 466 of the Senate amendment and secs. 357 and 361 of the Code)

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a controlled subsidiary ("controlled") tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the controlled corporation that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under section 355 and that are considered 'acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will

[903] Sec. 453(f)(3). Instead, the receipt of such indebtedness is treated as a receipt of payment.

recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

House Bill

No provision.

Senate Amendment

The bill limits the amount of money plus the fair market value of other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the bill provides that acquisitive reorganizations under section 368(a)(1)(D) are no longer subject to the liabilities assumption rules of section 357(c).

Effective date.–The bill is effective for transactions on or after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

19. Clarify definition of nonqualified preferred stock (sec. 467 of the Senate amendment and sec. 351(g) of the Code)

Present Law

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. For this purpose, preferred stock is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

House Bill

No provision.

Senate Amendment

The provision clarifies the definition of nonqualified preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

As one example, instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred stockholders. As another example, stock that entitles the holder to a dividend that is the greater of seven percent or the dividends common shareholders receive does not avoid being preferred stock if the common shareholders are not expected to receive dividends greater than seven percent.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective date.–The provision is effective for transactions after May 14, 2003.

Conference Agreement

The conference agreement follows the Senate amendment.

20. Modify definition of controlled group of corporations (sec. 468 of the Senate amendment and sec. 1563 of the Code)

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0 - $50,000	15 percent of taxable income
$50,001 - $75,000	25 percent of taxable income
$75,001 - $10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333.

The component members of a controlled group of corporations are limited to one amount in each of the taxable income brackets shown above.[904] For this purpose, a controlled group of corporations means a parent-subsidiary controlled group and a brother-sister controlled group.

A brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all stock, and (2) more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.[905]

House Bill

No provision.

Senate Amendment

Under the provision, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

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[904] Component members are also limited to one alternative minimum tax exemption and one accumulated earnings credit.

[905] Sec. 1563(a)(2). The Supreme Court held in *United States v. Vogel Fertilizer*, 455 US 16 (1982), that Treas. Reg. Sec. 1.1563-1(a)(3), as it was then written, was invalid insofar as it would require an individual's stock to be taken into account, for purposes of the 80-percent brother-sister corporation ownership test, where that individual did not own stock in each of the corporations in the asserted controlled group. In that case, one corporation was owned 77.49 percent by one shareholder and 22.51 by an unrelated shareholder. The 77.49 percent shareholder of that first corporation also owned 87.5 percent of the voting stock and more than 90 percent of the value of the stock of a second corporation. The Supreme Court held the corporations were not a controlled group, even though they would have been one had the then applicable Treasury regulations been considered valid in their application to the case. The Treasury regulations were subsequently changed to conform to the Supreme Court decision. T.D. 8179, 53 F.R. 6603 (March 2, 1988).

The provision applies only for purposes of section 1561, currently relating to corporate tax brackets, the accumulated earnings credit, and the minimum tax. The provision does not affect other Code sections or other provisions that utilize or refer to the section 1563 brother-sister corporation controlled group test for other purposes.[906]

Effective date.–The provision applies to taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

21. Establish specific class lives for utility grading costs (sec. 472 of the Senate amendment and sec. 168 of the Code)

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system ("MACRS") using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[907] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs.

[906] As one example, the provision does not change the present law standards relating to deferred compensation, contained in subchapter D of the Code, that refer to section 1563.

[907] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

House Bill

No provision.

Senate Amendment

The Senate amendment assigns a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The provision includes these assets in the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective date.–The Senate amendment is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

22. Expansion of limitation on expensing of certain passenger automobiles (sec. 473 of the Senate amendment and sec. 179 of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over five years. However, section 280F limits the annual depreciation deduction with respect to certain passenger automobiles.[908]

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads,

[908] The limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles (subject to the such limitation) placed in service in 2002, the maximum amount of allowable depreciation is $7,660 for the year in which the vehicle was placed in service, $4,900 for the second year, $2,950 for the third year, and $1,775 for the fourth and later years. This limitation applies to the combined depreciation deduction provided under present law for depreciation, including section 179 expensing and the temporary 30 percent additional first year depreciation allowance. For luxury automobiles eligible for the 50% additional first depreciation allowance, the first year limitation is increased by an additional $3,050.

and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[909] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sports utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment (sec. 179). The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[910] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[911] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.

House Bill

No provision.

Senate Amendment

The Senate amendment limits the ability of taxpayers to claim deductions under section 179 for certain vehicles not subject to section 280F to $25,000. The provision applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the present law 6,000 pound rating). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

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[909] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

[910] Pub. L. No. 108-27, sec. 202 (2003).

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

The following example illustrates the operation of the provision.

Example.–Assume that during 2005, a calendar year taxpayer acquires and places in service a sport utility vehicle subject to the provision that costs $70,000. In addition, assume that the property otherwise qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $25,000 deduction under section 179. The taxpayer is also allowed an additional first-year depreciation deduction (sec. 168(k)) of $22,500 based on $45,000 ($70,000 original cost less the section 179 deduction of $25,000) of adjusted basis. Finally, the remaining adjusted basis of $22,500 ($45,000 adjusted basis less $22,500 additional first-year depreciation) is eligible for an additional depreciation deduction of $4,500 under the general depreciation rules (automobiles are five-year recovery property). The remaining $18,000 of cost ($70,000 original cost less $52,000 deductible currently) would be recovered in 2006 and subsequent years pursuant to the general depreciation rules.

Effective date.–The Senate amendment is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

23. Provide consistent amortization period for intangibles (sec. 474 of the Senate amendment and secs. 195, 248, and 709 of the Code)

Present Law

At the election of the taxpayer, start-up expenditures[912] and organizational expenditures[913] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[914] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and

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[912] Sec. 195

[913] Secs. 248 and 709.

[914] Treas. Reg. sec. 1.195-1.

organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the treatment of start-up and organizational expenditures. A taxpayer would be allowed to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective date.--The Senate amendment is effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

Conference Agreement

The conference agreement follows the Senate amendment.

24. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 483 of the Senate amendment)

Present Law

The Code contains numerous civil penalties, such as the delinquency, accuracy-related and fraud penalties. These civil penalties are in addition to any interest that may be due.

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") running through April 15, 2003, to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. The taxpayer will pay back taxes, interest and certain accuracy-related and delinquency penalties.

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. A voluntary disclosure does not guarantee immunity from prosecution.

House Bill

No provision.

Senate Amendment

Increases by a factor of two the total amount of civil penalties, interest and fines applicable for taxpayers who would have been eligible to participate in either the OVCI or the Treasury Department's voluntary disclosure initiative but did not participate in either program.

Effective date.–Taxpayers' open tax years on or after date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

25. Whistleblower reforms (sec. 488 of the Senate amendment)

Present Law

Under section 7623, the IRS is authorized to pay such sums as deemed necessary for: "(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same." Amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided. For specific information that caused the investigation and resulted in recovery, the IRS administratively has set the reward in an amount not to exceed 15 percent of the amounts recovered. For information, although not specific, that nonetheless caused the investigation and was of value in the determination of tax liabilities, the reward is not to exceed 10 percent of the amount recovered. For information that caused the investigation, but had no direct relationship to the determination of tax liabilities, the reward is not to exceed one percent of the amount recovered. The reward ceiling is $10 million (for payments made after November 7, 2002), and the reward floor is $100. No reward will be paid if the recovery was so small as to call for payment of less than $100 under the above formulas. Both the ceiling and percentages can be increased with a Special Agreement. The Code permits the IRS to disclose return information pursuant to a contract for tax administration services (sec. 6103(n)).

House Bill

No provision.

Senate Amendment

The Senate amendment creates a reward program for actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $20,000, and, if the taxpayer is an individual, the individual's gross income exceeds $200,000 for any taxable year.

Generally, the Senate amendment establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS proceeds with an administrative or judicial action based on information brought to the IRS's attention by an individual. The Senate amendment permits awards of lesser amounts (but no less than 10 percent) if the action was based principally on allegations (other than information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media. The Senate amendment caps the available reward at 30 percent of the collected proceeds. Any determination regarding a reward may be appealed to the U.S. Tax Court.

The Senate amendment creates a Whistleblower Office within the IRS to administer this reward program. The Whistleblower Office is funded with amounts equal to rewards made. The Whistleblower Office may seek the assistance from the individual providing information or from his legal representative, and may reimburse the costs incurred by any legal representative out of the funds of the Whistleblower Office. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

Effective date.–Information provided on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

26. Increase in age of minor children whose unearned income is taxed as if parent's income (sec. 495 of the Senate amendment and sec. 1 of the Code)

Present Law

Filing requirements for children

A single unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income only over $4,850 (for 2004); (2) unearned income only over the minimum standard deduction amount for dependents ($800 in 2004); or (3) both earned income and unearned income totaling more than the smaller of (a) $4,850 (for 2004) or (b) the larger of (i) $800 (for 2004), or (ii) earned income plus $250.[915] Thus, if a dependent child has less than $800 in gross income, the child does not have to file an individual income tax return for 2004.[916]

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income under section 1(g)

Special rules (generally referred to as the "kiddie tax") apply to the unearned income of a child who is under age 14.[917] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year; (2) the child's unearned income was more than $1,600 (for 2004); and (3) the child is required to file a return for the year. The kiddie tax applies regardless of whether the child may be claimed as a dependent on the parent's return.

For these purposes, unearned income is income other than wages, salaries, professional fees, or other amounts received as compensation for personal services actually rendered.[918] For children under age 14, net unearned income (for 2004, generally unearned income over $1,600) is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $1,600 (for 2004), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[919]

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum

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[915] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 3, Table 1 (2003).

[916] A taxpayer generally need not file a return if he or she has gross income in an amount less than the standard deduction (and, if allowable to the taxpayer, the personal exemption amount). An individual who may be claimed as a dependent of another taxpayer is not eligible to claim the dependency exemption relating to that individual. Sec. 151(d)(2). For taxable years beginning in 2004, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $800 or the sum of $250 and the individual's earned income.

[917] Sec. 1(g).

[918] Sec. 1(g)(4) and sec. 911(d)(2).

[919] Sec. 1(h).

of (1) the minimum standard deduction allowed to dependents ($800 for 2004), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[920] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Special rules apply to determine which parent's tax return and rate is used to calculate the kiddie tax. If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[921]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return to report the child's income.[922] In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax on the child's unearned income, or

(2) the tax on the child's income without regard to the kiddie tax provisions..

Parental election to include child's dividends and interest on parent's return

Under certain circumstances, a parent may elect to report a child's dividends and interest on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The parent makes the election on Form 8814,

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[920] Sec. 1(g)(4).

[921] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 6 (2003).

[922] The child must attach to the return Form 8615, Tax for Children Under Age 14 With Investment Income of More Than $1,500 (2003).

Parents' Election To Report Child's Interest and Dividends. The requirements for the parent's election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[923]

(2) such income is more than the minimum standard deduction amount for dependents ($800 in 2004) and less than 10 times that amount ($8000 in 2004);

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,600 for 2004). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $80 (in 2004), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($800 in 2004).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[924] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[925] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[926]

<u>Taxation of compensation for services under section 1(g)</u>

Compensation for a child's services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g., is the parent's income under local law).[927] If the child's income tax is not paid, however, an assessment against

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[923] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2003).

[924] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2003).

[925] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2003).

[926] Sec. 1(g)(7)(B).

[927] Sec. 73(a).

the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[928]

House Bill

No provision.

Senate Amendment

The Senate amendment increases the age of minors to which the kiddie tax provisions apply from under 14 to under 18.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

27. Modify holding period requirement for qualification for reduced tax rate on dividends on preferred stock (sec. 496 of the Senate amendment and sec. 1 of the Code)

Present Law

Section 1(h)(11) provides that if a taxpayer receives "qualified dividend income," the dividend income is taxed as net capital gain. The maximum rate of tax on qualified dividend income therefore generally is 15 percent.[929] Dividends are treated as qualified dividend income only if certain conditions, including holding period requirements, are satisfied. The holding period requirements under section 1(h)(11) are defined by reference, with modifications, to the holding period requirements under section 246(c) for qualification for the dividends received deduction. A dividend paid on a share of common stock is qualified dividend income only if, among other requirements, the recipient holds the share for more than 60 days during the 121-day period beginning on the date that is 60 days before the date on which the share becomes ex-dividend with respect to the dividend.[930] A dividend paid on a share of preferred stock is qualified dividend income only if the recipient holds the share for more than 90 days during the 181-day period beginning 90 days before the ex-dividend date.[931]

House Bill

No provision.

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[928] Sec. 6201(c).

[929] Sec. 1(h)(1)(C).

[930] Secs. 1(h)(11)(B)(iii)(I), 246(c)(1)(A).

[931] Secs. 1(h)(11)(B)(iii)(I), 246(c)(2).

Senate Amendment[932]

The Senate amendment changes the holding period requirement for treatment as qualified dividend income for dividends paid on preferred stock. Under the Senate amendment, stock must be held for more than 120 days during the 240-day period beginning 120 days before the ex-dividend date.

Effective date.–The Senate amendment provision applies to taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

28. Grant Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income (sec. 661A of Senate amendment and sec. 901 of the Code)

Present Law

The United States provides a credit for foreign income taxes paid or accrued. For purposes of the foreign tax credit, the taxpayer "is the person on whom foreign law imposes legal liability for such tax." Treas. Reg. sec. 1.901-2(f)(1). Thus, if a U.S. corporation owns a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This is true even if the U.S. corporation elects to treat the foreign entity as a corporation for U.S. tax purposes. If the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of an anti-deferral regime, the income generated by the foreign entity may never be reported on a U.S. return, despite the fact that the U.S. corporation can claim credits for taxes imposed on that income.

The Treasury Department and the IRS have expressed concern about transactions that involve inappropriate foreign tax credit results, including the second class of transactions described in Notice 98-5.[933] The tax benefits claimed in these transactions are inconsistent with the purposes of the foreign tax credit provisions.[934]

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[932] The Senate amendment predated the enactment of H.R. 1308, Pub. L. No. 108-311 (the "Working Families Tax Relief Act of 2004"), which included a technical correction to the holding period requirements under sections 1(h)(11) and 246(c) (increasing from 120 to 121 days and from 180 to 181 days the periods during which the stock holding requirements are tested).

[933] 1998-1 C.B. 334.

[934] Notice 2004-19, 2004-11 I.R.B. 606.

House Bill

No provision.

Senate Amendment

The provision expands existing regulatory authority to provide Treasury and the IRS additional mechanisms to address the second class of transactions described in Notice 98-5 as well as other abusive foreign tax credit schemes that involve the inappropriate separation of foreign taxes from the related foreign income in cases where foreign taxes are imposed on any person with respect to income of an entity.

The regulations may provide for: (1) the disallowance of a credit for all or a portion of the foreign taxes; or (2) for the allocation of the foreign taxes among the participants in the transaction in a manner that is more consistent with the underlying economics of the transaction.

Effective date.–The provision is effective for transactions entered into after the date of enactment.

Conference Agreement

No provision.

29. Freeze of provision regarding suspension of interest where Secretary fails to contact taxpayer (sec. 662B of the Senate amendment and sec. 6404(g) of the Code)

Present Law

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest after 1 year after the filing of the tax return[935] if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period.[936] With respect to taxable years beginning before January 1, 2004, the one-year period is increased to 18 months. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

[935] If the return is filed before the due date, for this purpose it is considered to have been filed on the due date.

[936] Sec. 6404(g). This provision was added to the Code by sec. 3305 of the IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, July 22,1998).

House Bill

No provision.

Senate Amendment

The Senate amendment makes the 18-month rule the permanent rule. The Senate amendment also adds gross misstatements[937] and listed and reportable transactions to the list of provisions to which the suspension of interest rules do not apply.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2003,[938] except that the addition of listed and reportable transactions applies to interest accruing after May 5, 2004.

Conference Agreement

The conference agreement follows the Senate amendment, except: (1) the provision relating to reportable transactions is made applicable only to reportable avoidance transactions;[939] and (2) that the addition of listed and reportable avoidance transactions applies to interest accruing after October 3, 2004.

30. Increase in withholding from supplemental wage payments in excess of $1 million (sec. 673 of the Senate amendment and sec. 13273 of the Revenue Reconciliation Act of 1993)

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to

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[937] This includes any substantial omission of items to which the six-year statute of limitations applies (sec. 6051(e)), gross valuation misstatements (sec. 6662(h)), and similar provisions.

[938] It is intended that this provision apply retroactively to the period beginning January 1, 2004 and ending on the date of enactment. The due date for returns for the taxable period beginning January 1, 2004 is generally April 15, 2005; April 15, 2005 is therefore the date from which the 12-month period that must pass under present-law prior to the commencement of suspension is calculated. Consequently, suspension of interest would generally not begin until April 15, 2006. Accordingly, the provision has no actual retroactive effect.

[939] A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

withholding at a flat rate,[940] based on the third lowest income tax rate under the Code (25 percent for 2005).[941]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (35 percent for 2004 and 2005), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) are not affected.

Effective date.–The provision is effective with respect to payments made after December 31, 2003.

Conference Agreement

The conference agreement follows the Senate amendment except that the conference agreement is effective for payments made after December 31, 2004.

31. Capital gain treatment on sale of stock acquired from exercise of statutory stock options to comply with conflict of interest requirements (sec. 674 of the Senate amendment and sec. 421 of the Code)

Present Law

Statutory stock options

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. Upon such exercise, an employer is allowed a corresponding compensation deduction. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[942]

If an employee disposes of stock acquired upon the exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market

[940] Sec. 13273 of the Revenue Reconciliation Act of 1993.

[941] Sec. 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

[942] Sec. 421.

value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within two years after the date the option is granted or one year after the date the option is exercised. The gain upon a disposition that occurs prior to the expiration of the applicable holding period(s) (a "disqualifying disposition") does not qualify for capital gains treatment. In the event of a disqualifying disposition, the income attributable to the disposition is treated by the employee as income received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Sale of property to comply with conflict of interest requirements

The Code provides special rules for recognizing gain on sales of property which are required in order to comply with certain conflict of interest requirements imposed by the Federal Government.[943] Certain executive branch Federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, an eligible person who, in order to comply with Federal conflict of interest requirements, is required to sell shares of stock acquired pursuant to the exercise of a statutory stock option is treated as satisfying the statutory holding period requirements, regardless of how long the stock was actually held. An eligible person generally includes an officer or employee of the executive branch of the Federal Government (and any spouse or minor or dependent children whose ownership in property is attributable to the officer or employee). Because the sale is not treated as a disqualifying disposition, the individual is afforded capital gain treatment on any resulting gains. Such gains are eligible for deferral treatment under section 1043.

The employer granting the option is not allowed a deduction upon the sale of the stock by the individual.

Effective date.–The Senate amendment is effective for sales after the date of enactment.

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[943] Sec. 1043.

Conference Agreement

The conference agreement follows the Senate amendment.

32. Application of basis rules to nonresident aliens (sec. 675 of the Senate amendment and new sec. 72(w) and sec. 83 of the Code)

Present Law

Distributions from retirement plans

Distributions from retirement plans are includible in gross income under the rules relating to annuities[944] and, thus, are generally includible in income, except to the extent the amount received represents investment in the contract (i.e., the participant's basis). The participant's basis includes amounts contributed by the participant on an after-tax basis, together with certain amounts contributed by the employer, minus the aggregate amount (if any) previously distributed to the extent that such amount was excludable from gross income. Amounts contributed by the employer are included in the calculation of the participant's basis only to the extent that such amounts were includible in the gross income of the participant, or to the extent that such amounts would have been excludable from the participant's gross income if they had been paid directly to the participant at the time they were contributed.[945]

Employer contributions to retirement plans and other payments for labor or personal services performed outside the United States by a nonresident alien generally are not treated as U.S. source income. Such contributions, therefore, generally would not be includible in the nonresident alien's gross income if they had been paid directly to the nonresident alien at the time they were contributed. Consequently, the amounts of such contributions generally are includible in the employee's basis and are not taxed by the United States if a distribution is made when the employee is a U.S. citizen or resident.[946]

Earnings on contributions are not included in basis unless previously includible in income. In general, in the case of a nonexempt trust, earnings are includible in income when distributed or made available.[947] In the case of highly compensated employees, the amount of the vested accrued benefit under the trust (other than the employee's investment in the contract) is generally required to be included in income annually (to the extent not previously includible). That is, earnings, as well as contributions, that are part of the vested accrued benefit are currently includible in income.[948]

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[944] Secs. 72 and 402.

[945] Sec. 72(f).

[946] Rev. Rul. 58-236, 1958-1 C.B. 37.

[947] Sec. 402(b)(2).

[948] Sec. 402(b)(4).

Property transferred in connection with the performance of services

The Code contains rules governing the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, in general, an amount is includible in the gross income of the person performing the services (the "service provider") for the taxable year in which the property is first vested (i.e., transferable or not subject to a substantial risk of forfeiture).[949] The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. Basis in such property includes any amount that is included in income as a result of the transfer.[950]

U.S. income tax treaties

Under the 1996 U.S. Model Income Tax Treaty ("U.S. Model") and some U.S. income tax treaties in force, retirement plan distributions beneficially owned by a resident of a treaty country in consideration for past employment generally are taxable only by the individual recipient's country of residence. Under the U.S. Model treaty and some U.S. income tax treaties, this exclusive residence-based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a retirement plan's earnings, subsequent distributions to that person while a resident of the United States would not be taxable in the United States to the extent the distributions were attributable to such previously taxed amounts.

Compensation of employees of foreign governments or international organizations

Under section 893, wages, fees, and salaries of any employee of a foreign government or international organization (including a consular or other officer or a nondiplomatic representative) received as compensation for official services to the foreign government or international organization generally are excluded from gross income when (1) the employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines (whether or not a citizen of the United States); (2) in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the United States in foreign countries; and (3) in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the United States performing similar services in such foreign country. The Secretary of State certifies the names of the foreign countries which grant an equivalent exclusion to employees of the United States performing services in those countries, and the character of those services.

The exclusion does not apply to employees of controlled commercial entities or employees of foreign governments whose services are primarily in connection with commercial activity (whether within or outside the United States) of the foreign government.

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[949] Sec. 83(a).

[950] Treas. Reg. sec. 1.61-2(d)(i).

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the present-law rules under which certain contributions and earnings that have not been previously taxed are treated as basis (under sec. 72). Under the Senate amendment, employee or employer contributions are not included in basis if: (1) the employee was a nonresident alien at the time the services were performed with respect to which the contribution was made; (2) the contribution is with respect to compensation for labor or personal services from sources without the United States; and (3) the contribution was not subject to income tax under the laws of the United States or any foreign country.

The Senate amendment authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of the Senate amendment, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances.

Effective date.–The Senate amendment is effective for distributions occurring on or after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with modifications.

Under the conference agreement, employee or employer contributions are not included in basis (under sec. 72) if: (1) the employee was a nonresident alien at the time the services were performed with respect to which the contribution was made; (2) the contribution is with respect to compensation for labor or personal services from sources without the United States; and (3) the contribution was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were rendered) under the laws of the United States or any foreign country.

Additionally, earnings on employer or employee contributions are not included in basis if: (1) the earnings are paid or accrued with respect to any employer or employee contributions which were made with respect to compensation for labor or personal services; (2) the employee was a nonresident alien at the time the earnings were paid or accrued; and (3) the earnings were not subject to income tax under the laws of the United States or any foreign country.

The conference agreement does not change the rules applicable to calculation of basis with respect to contributions or earnings while an employee is a U.S. resident.

There is no inference that this conference agreement applies in any case to create tax jurisdiction with respect to wages, fees, and salaries otherwise exempt under section 893. Similarly, there is no inference that the conference agreement applies where contrary to an agreement of the United States that has been validly authorized by Congress (or in the case of a treaty, ratified by the Senate), and which provides an exemption for income.

Most U.S. tax treaties specifically address the taxation of pension distributions. The U.S. Model treaty provides for exclusive residence-based taxation of pension distributions to the extent such distributions were not previously included in taxable income in the other country. For purposes of the U.S. Model treaty, the United States treats any amount that has increased the recipient's basis (as defined in section 72) as having been previously included in taxable income. The following example illustrates how the conference agreement could affect the amount of a distribution that may be taxed by the United States pursuant to a tax treaty.

Assume the following facts. A, a nonresident alien individual, performs services outside the United States, in A's country of residence, country Z. A's employer makes contributions on behalf of A to a pension plan established in country Z. For U.S. tax purposes, no portion of the contributions or earnings are included in A's income (and would not be included in income if the amounts were paid as cash compensation when the services were performed) because such amounts relate to services performed without the United States.[951] Later in time, A retires and becomes a permanent resident of the United States.

Under the conference agreement, the employer contributions to the pension plan would not be taken into account in determining A's basis if A was not subject to income tax on the contributions by a foreign country and the contributions would have been subject to tax by a foreign country if the contributions had been paid to A as cash compensation when the services were performed. Thus, in those circumstances, A would be subject to U.S. tax on the distribution of all of the contributions, as such distributions are made. However, if the contributions would not have been subject to tax in the foreign country if they had been paid to A as cash compensation when the services were performed, under the conference agreement, the contributions would be included in A's basis. Earnings that accrued while A was a nonresident alien would not result in basis if not taxed under U.S. or foreign law. Earnings that accrued while A was a permanent resident of the United States would be subject to present-law rules. This result generally is consistent with the treatment of pension distributions under the U.S. Model treaty.

The conference agreement authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of the conference agreement, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances. For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the "subject to income tax" requirement.

The conference agreement also changes the rules for determining basis in property received in connection for the performance of services in the case of an individual who was a nonresident alien at the time of the performance of services, if the property is treated as income from sources outside the United States. In that case, the individual's basis in the property does not include any amount that was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were performed) under the laws of the United States or any foreign country.

[951] Sec. 872.

Effective date.–The conference agreement is effective for distributions occurring on or after the date of enactment. No inference is intended that the earnings subject to the conference agreement are included in basis under present law.

33. Residence and source rules related to a United States possession (sec. 497 of the Senate amendment and new sec. 937 of the Code)

Present Law

In general

Generally, U.S. citizens are subject to U.S. income taxation on their worldwide income. Thus, all income earned by U.S. citizens is subject to U.S. income tax, regardless of its source.

The U.S. income taxation of alien individuals varies depending on whether they are resident or non-resident aliens. A resident alien is generally taxed in the same manner as a U.S. citizen.[952] In contrast, a nonresident alien is generally subject to U.S. tax only on certain gross U.S. source income at a flat 30 percent rate (unless such rate is eliminated or reduced by treaty) and on net income that has a sufficient nexus to the United States at the graduated rates applicable to U.S. citizens and residents under section 1.

An alien is considered a resident of the United States if the individual: (1) has entered the United States as a lawful permanent resident and is such a resident at any time during the calendar year, (2) is present in the United States for a substantial period of time (the so-called "substantial presence test"), or (3) makes an election to be treated as a resident of the United States (sec. 7701(b)). An alien who does not meet the definition of a "resident alien" is considered to be a non-resident alien for U.S. income tax purposes.

Under the substantial presence test, an alien individual is generally treated as a resident alien if he or she is present in the United States for 31 days during the taxable year and the sum of the number of days on which such individual was present in the United States (when multiplied by the applicable multiplier) during the current year and the preceding two calendar years equals or exceeds 183 days. The applicable multiplier for: the current year is one; the first preceding year is one-third; and the second preceding year is one-sixth.

An alien individual who meets the above test may nevertheless be a nonresident if he or she (1) is present in the United States for fewer than 183 days during the current year; (2) has a tax home in a foreign country during the year; and (3) has a closer connection to that country than to the United States.

For purposes of the substantial presence test, the United States includes the states and the District of Columbia, but does not include U.S. possessions. An individual is present in the United States for a particular day if he or she is physically present in the United States during any time during such day. However, in certain circumstances an individual's presence in the

[952] Section 7701(a)(30) defines a citizen or resident of the United States as "U.S. persons."

United States is ignored, including presence in the United States as a result of certain medical emergencies.

U.S. income taxation of residents of U.S. possessions

Generally, special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of certain U.S. possessions (i.e., Puerto Rico, Virgins Islands, Guam, Northern Mariana Islands and American Samoa) and who have possession source income or income effectively connected to the conduct of a trade or business within a possession.

Generally, a bona fide resident of a U.S. possession (regardless of whether the individual is a U.S. citizen or alien) is determined using the principles of a subjective, facts-and-circumstances test set forth in the regulations under section 871. Prior to the adoption of present-law section 7701(b), this subjective test was used to determine whether an alien individual was a resident of the United States. Under these rules, an individual is generally a resident of the United States if an individual (1) is actually present in the United States, and (2) is not a mere transient or sojourner.[953] Whether individuals are transients is determined by their intentions with regard to the length and nature of their stay. However, the regulations provide that section 7701(b) (discussed above) provides the basis for determining whether an alien individual is a resident of a U.S. possession with a mirror income tax code.[954]

Pursuant to regulations, the principles that generally apply for determining income from sources within and without the United States also generally apply in determining income from sources within and without a U.S. possession.[955] The Code and regulations do not indicate how to determine whether income is effectively connected with the conduct of a trade or business within a U.S. possession. However, section 864(c) provides rules for determining whether income is effectively connected to a trade or business conducted within the United States.

Information reporting

Section 7654(e) provides that Treasury may require information reporting with respect to individuals that may take advantage of certain special U.S. income tax rules with respect to U.S. possessions. Section 6688 provides that an individual may be subject to a $100 penalty if the individual fails to furnish the information required by regulations issued pursuant to section 7654(e).

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[953] Treas. Reg. sec. 1.871-2(b).

[954] A U.S. possession with a mirror income tax code is "a United States possession . . . that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term 'United States' where appropriate) to those in the United States." Treas. Reg. sec. 7701(b)-1(d)(1).

[955] Treas. Reg. sec. 1.863-6.

House Bill

No provision.

Senate Amendment

The provision provides the term "bona fide resident" means a person who satisfies a test, determined by the Secretary, similar to the substantial presence test of section 7701(b)(3) with respect to Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands.

The provision also requires bona fide residents of the Virgin Islands to file an informational income tax return with the United States and imposes a penalty for the failure to file such a return.

Effective date.–The provision is effective for taxable years ending after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with modifications.

The conferees understand that certain U.S. citizens and residents are claiming that they are exempt from U.S. income tax on their worldwide income based on a position that they are bona fide residents of the Virgin Islands or another possession. However, these individuals often do not spend a significant amount of time in the particular possession during a taxable year and, in some cases, continue to live and work in the United States. Under the Virgin Island's Economic Development Program, many of these same individuals secure a reduction of up to 90 percent of their Virgin Islands income tax liability on income they take the position is Virgin Islands source or effectively connected with the conduct of a Virgin Islands trade or business. The conferees are also aware that taxpayers are taking the position that income earned for services performed in the United States is Virgin Islands source or that their U.S. activities generate income effectively connected with the conduct of a Virgin Islands trade or business.

The conferees believe that the various exemptions from U.S. tax provided to residents of possessions should not be available to individuals who continue to live and work in the United States. The conferees also believe that the special U.S. income tax rules applicable to residents in a possession need to be rationalized. The conferees are further concerned that the general rules for determining whether income is effectively connected with the conduct of a trade or business in a possession present numerous opportunities for erosion of the U.S. tax base.

Generally, the provision provides that the term "bona fide resident" means a person who meets a two-part test with respect to Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands, as the case may be, for the taxable year. First, an individual must be present in the possession for at least 183 days in the taxable year. Second, an individual must (i) not have a tax home outside such possession during the taxable year and (ii) not have a closer connection to the United States or a foreign country during such year.

The provision also grants authority to Treasury to create exceptions to these general rules as appropriate. The conferees intend for such exceptions to cover, in particular, persons whose presence outside a possession for extended periods of time lacks a tax avoidance purpose, such as military personnel, workers in the fisheries trade, and retirees who travel outside the possession for certain personal reasons.

An individual is present in a possession for a particular day if he is physically present in such possession during any time during such day. In certain circumstances an individual's presence outside a possession is ignored (e.g., certain medical emergencies) as provided under the principles of section 7701(b).

The provision provides that a taxpayer must file a notice in the first taxable year they claim bona fide residence in a possession. The provision imposes a penalty of $1000 for the failure to file such notice or to comply with any filing required by regulation under section 7654(e).

The provision generally codifies the existing rules for determining when income is considered to be from sources within a possession by providing that, as a general rule, for all purposes of the Code, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the provision provides that the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, the provision further provides that except as provided in regulations any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.

The provision also grants authority to the Secretary of the Treasury to create exceptions to these general rules regarding possession source income and income effectively connected with a possession trade or business as appropriate. The conferees anticipate that this authority will be used to continue the existing treatment of income from the sale of goods manufactured in a possession. The conferees also intend for this authority to be used to prevent abuse, for example, to prevent U.S. persons from avoiding U.S. tax on appreciated property by acquiring residence in a possession prior to its disposition.

No inference is intended as to the present-law rules for determining (1) bona fide residence in a possession, (2) whether income is possession source, and (3) whether income is effectively connected with the conduct of a trade or business within a possession.

<u>Effective date</u>.– Generally, the provision is effective for taxable years ending after the date of enactment. The first prong of the two-part residency test (i.e., the 183-day test) is effective for taxable years beginning after date of enactment. The general effective date applies with respect to the second prong of such test. The rule providing that income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with the conduct of a

trade or business within any such possession is effective for income earned after date of enactment.

34. Include employer provided housing under foreign earned income exclusion cap (sec. 632 of the Senate amendment and sec. 911 of the Code)

Present Law

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. However, the United States generally cedes the primary right to tax income derived by a U.S. citizen from sources outside the United States to the foreign country where such income is derived. Accordingly, a credit against the U.S. income tax imposed on foreign source income is generally available for foreign taxes paid on that income, to the extent of the U.S. tax otherwise owed on such income. If the foreign income tax rate is lower than the U.S. income tax rate, then the United States generally provides a credit up to the amount of the foreign tax and imposes a residual tax to the extent of the difference.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs, in which case no residual U.S. tax is imposed to the extent of such exclusion, regardless of the foreign tax rate. In order to qualify for these exclusions, an individual must be either: (1) a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year;[956] or (2) a U.S. citizen or resident present overseas for 330 days out of any 12-consecutive-month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The foreign earned income exclusion generally applies to income earned from sources outside the United States as compensation for personal services rendered by the taxpayer. The maximum exclusion amount for foreign earned income is $80,000 per taxable year for 2002 and thereafter. For taxable years beginning after 2007, the maximum exclusion amount is indexed for inflation.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing in a foreign country but only to the extent the housing costs exceed a base housing amount. The base housing amount is equal to 16 percent of the annual salary earned by a GS-14, Step 1 U.S. government employee. In the case of housing costs that are not paid or reimbursed by the taxpayer's employer, the amount that would be excludible is treated instead as a deduction.

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[956] Only U.S. citizens may qualify under the bona fide residence test. However, resident aliens of the United States who are citizens of foreign countries that have a treaty with the United States may qualify for section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision.

The combined foreign earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of such credit that is attributable to excluded income.

House Bill

No provision.

Senate Amendment

The provision applies the annual foreign earned income exclusion cap to the combined value of foreign earned income and employer-provided housing amounts.

The present-law provision providing indexation for inflation for tax years beginning after 2007 remains unchanged. The present law provision imposing an additional foreign earned income cap on exclusions and deductions also remains unchanged.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

35. Deduction for personal use of company aircraft and other entertainment expenses (sec. 103(b) of the Senate amendment and sec. 274(e) of the Code)

Present Law

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.[957] The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[958] The deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or award.[959] The exceptions apply only to the extent that amounts are properly reported by the

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[957] Sec. 274(a).

[958] Sec. 274(e)(2).

[959] Sec. 274(e)(9).

company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[960] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[961] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[962]

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation has been interpreted as not limiting the company's deduction for operation of the aircraft to the amount of compensation reportable to its employees,[963] which can result in a deduction multiple times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, in the case of covered employees, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Covered employees are defined as under section 162(m)(3) and include the chief executive officer (or individual acting in such capacity) and the four highest-compensated officers of publicly-traded corporations. No deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the

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[960] Treas. Reg. sec. 1.61-21.

[961] Treas. Reg. sec. 1.61-21(g).

[962] Treas. Reg. sec. 1.61-21(b)(6).

[963] *Sutherland Lumber-Southwest, Inc. v. Comm.*, 114 T.C. 197 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (Feb. 11, 2002).

covered employee. For example, a company's deduction attributable to aircraft operating costs for a covered employee's vacation use of a company aircraft is limited to the amount reported as compensation to the employee. As under present law, the amount of the deduction cannot exceed the actual cost.

The provision is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Commissioner* with respect to covered employees. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Effective date.–The Senate amendment is effective for expenses incurred after the date of enactment and before January 1, 2006.

Conference Agreement

The conference agreement follows the Senate amendment except that the provision applies with respect to individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)),[964] directors, and 10-percent-or-greater owners of private and publicly-held companies.

Effective date.–The conference agreement is effective for amounts deferred after the date of enactment.

36. Treatment of contingent payment convertible debt instruments (sec. 733 of the Senate Amendment and sec. 1275 of the Code)

Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount ("OID"), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument

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

through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of such instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.[965] The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.[966] The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.[967]

In the case of contingent payment debt instruments that are issued for money or publicly traded property,[968] the regulations provide that interest on a debt instrument must be taken into account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the "noncontingent bond method"). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.[969]

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature)--often referred to as "contingent convertible" debt instruments--the IRS has stated that the

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[965] Treas. reg. sec. 1.1275-4.

[966] Treas. reg. sec. 1.1275-4(a)(4).

[967] Treas. reg. sec. 1.1275-4(a)(5).

[968] Treas. reg. sec. 1.1275-4(b).

[969] Treas. reg. sec. 1.1275-4(b)(4)(i)(A).

noncontingent bond method applies in computing the accrual of OID on the debt instrument.[970] In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that, in the case of a contingent convertible debt instrument,[971] any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the Senate amendment, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

Effective date.–The Senate amendment provision is effective for debt instruments issued on or after date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[970] Rev. Rul. 2002-31, 2002-1 C.B. 1023.

[971] Under the bill, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

TITLE XI – TRADE PROVISIONS

A. Suspension of Duties on Ceiling Fans (sec. 801 of the House bill and Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

A 4.7-percent *ad valorem* customs duty is collected on imported ceiling fans from all sources.

House Bill

The House bill suspends the present customs duty applicable to ceiling fans through December 31, 2006.

Effective date.–The provision is effective on the fifteenth day after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the House bill provision.

B. Temporary Suspension of Certain Customs Duties

1. Suspension of duties on nuclear steam generators (sec. 802(a) of the House bill and Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

Nuclear steam generators, as classified under heading 9902.84.02 of the Harmonized Tariff Schedule of the United States, enter the United States duty free until December 31, 2006. After December 31, 2006, the duty on nuclear steam generators returns to the column 1 rate of 5.2 percent under subheading 8402.11.00 of the Harmonized Tariff Schedule of the United States.

House Bill

The House bill extends the present-law suspension of customs duty applicable to nuclear steam generators through December 31, 2008.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the House bill provision.

2. Suspension of Duties on Nuclear Reactor Vessel Heads (sec. 802(b) of the House bill and Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

According to section 5202 of the Trade Act of 2002, nuclear reactor vessel heads are classified under subheading 8401.40.00 of the Harmonized Tariff Schedule of the United States and enter the United States with a column 1 duty rate of 3.3 percent.

House Bill

The House bill temporarily suspends the present customs duty applicable to nuclear reactor vessel heads for column 1 countries through December 31, 2008.

Effective date.–The provision is effective on the fifteenth day after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement includes the House bill provision with a modification. The conference agreement also temporarily suspends the customs duty applicable to nuclear reactor pressurizers.

II. TAX COMPLEXITY ANALYSIS

The following tax complexity analysis is provided pursuant to section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998, which requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service ("IRS") and the Treasury Department) to provide a complexity analysis of tax legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or a Conference Report containing tax provisions. The complexity analysis is required to report on the complexity and administrative issues raised by provisions that directly or indirectly amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS and the Treasury Department regarding each of the provisions included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

1. Deduction relating to income attributable to United States production activities (sec. 102 of the House bill, secs. 102 and 103 of the Senate amendment, and sec. 11 of the Code)

Summary description of provision

The conference agreement provides a deduction attributable to certain qualified production activities in the United States of a C corporation, S corporation, partnership, or sole proprietorship. Such activities generally include: (1) manufacturing, production, growth or extraction of certain tangible personal property, computer software, property described in section 168(f)(3) or (4) of the Code, and electricity, natural gas, or potable water produced by the taxpayer; (2) construction; and (3) engineering or architectural services.

The amount of the deduction in taxable years beginning in 2005, 2006, 2007, 2008, 2009, and 2010 and thereafter generally is three, three, six, six, six, and nine percent, respectively. The deduction is limited for a taxable year to 50 percent of the wages paid by the taxpayer during such taxable year. In addition, the deduction cannot exceed the lesser of the taxpayer's taxable income (computed without regard to the deduction) or the taxpayer's qualified production activities income.

The bill is effective for taxable years beginning after 2004.

Number of affected taxpayers

It is estimated that the provision will affect more than 10 percent of small businesses.

Discussion

It is anticipated that small businesses engaged in qualified production activities will need to keep additional records due to this provision, and that extensive additional regulatory guidance will be necessary to effectively implement the provision. It is anticipated that the provision will result in an increase in disputes between small businesses and the IRS. Reasons for such disputes include the complexity of the provision and the inherent incentive for small businesses and other taxpayers to characterize their activities as qualified production activities to claim the deduction under the provision.

The provision likely will increase the tax preparation costs for most small businesses that are, or may be, engaged in qualified production activities. Small businesses will have to perform additional analysis and make subjective determinations concerning whether their activities constitute qualified production activities and, thus, whether income attributable to such activities qualifies for the deduction allowed under the provision. In this regard, the provision does not provide detailed definitions of the activities that produce income eligible for the deduction, and it will be difficult for the Treasury Secretary to define qualified production activities administratively. It should be noted that a similar provision in the Canadian tax laws was found to be highly complex and difficult to administer, which led to numerous disputes and litigation between affected taxpayers and the Canadian tax authorities. Canada recently repealed the provision and provided a general reduction in corporate tax rates.

For income that is determined to be eligible for the deduction under the provision, small businesses will be required to perform additional and complex calculations to determine the amount of the deduction under the provision. Because the deduction is based upon modified taxable income rather than gross income, small businesses will be required to undertake complicated calculations to determine the amount of costs that are allocable to gross income from qualified production activities. In many cases, small businesses would not have been required otherwise to perform these calculations but for the provision.

The wage limitation on the deduction is likely to impact small businesses disproportionately. After undertaking the calculations and analyses to determine the amount of their potential deduction, many small business will find that such amount is significantly reduced, or eliminated altogether, by the wage limitation.

Under the provision, it may be necessary for small businesses to make certain allocations of income that are not required under present law, particularly with respect to businesses that have both income that is directly attributable to qualified production activities and income that is attributable to processes associated with qualified production activities (e.g., vertically integrated manufacturers that also engage in the selling, storage, and installation of manufactured goods). To the extent the deduction under the provision is not based upon income from processes associated with qualified production activities, taxpayers that engage in such processes will be required to allocate their aggregate income between qualified production activities and processes associated with qualified production activities. In general, it is expected that the multiple calculations and analyses required by this provision will lead to intentional or inadvertent noncompliance among small businesses, as well as other taxpayers.

Due to the detailed calculations required by the provision, it is anticipated that the Secretary of the Treasury will have to make appropriate revisions to several types of income tax forms, schedules, spreadsheets and instructions.