1 EXECUTIVE COMMITTEE MEETING REGARDING THE CHAIRMAN'S MARK
2 ON TAX INCENTIVES TO ENCOURAGE CHARITABLE GIVING
3 THURSDAY, JUNE 13, 2002
4 U.S. Senate,
5 Committee on Finance,
6 Washington, DC.

Continued June 18th

7 The meeting was convened, pursuant to notice, at
8 10:09.m., in room 215, Dirksen Senate Office Building,
9 Hon. Max Baucus (chairman of the committee) presiding.
10 Also present: Senators Rockefeller, Breaux, Graham,
11 Bingaman, Lincoln, Grassley, Hatch, Murkowski, Nickles,
12 Gramm, Lott, Thompson, Snowe, Kyl, and Thomas.
13 Also present: John Angell, Staff Director; Mike
14 Evans, Chief Counsel and Deputy Staff Director; Kolan
15 Davis, Republican Staff Director and Chief Counsel; Carla
16 Martin, Chief Clerk.
17 Also present: Russell Sullivan, Chief Tax Counsel;
18 Dean Zerbe, Tax Counsel, Minority; Pamela Olsen, Acting
19 Assistant Secretary for Tax Policy; Lindy Paull, Chief of
20 Staff, Joint Tax Committee; Elizabeth Paris, Tax Counsel,
21 Minority; Dr. Elizabeth Fowler, Chief Health Policy
22 Director.
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1 OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM
2 MONTANA, CHAIRMAN, COMMITTEE ON FINANCE
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4 The Chairman. The committee will come to order.
5 We are meeting today to consider how we can help
6 charities help our communities.
7 At a time when all Americans have come together to
8 support the war against terrorism, I believe this is more
9 important than ever.
10 President Bush has said it well. "In order to fight
11 evil, we must do good. And it is the gathering momentum
12 of millions of acts of kindness and compassion which
13 define the true face of America."
14 We all remember what happened after September 11th.
15 Charities delivered food, woodier, clothing, and
16 counseling. And every day thereafter, charities worked
17 to provide even broader assistance to those affected by
18 the tragedies in New York, Northern Virginia, and
19 Pennsylvania.
20 The same kind of work goes on every day all across
21 the country in response not only to attacks and natural
22 disasters, but also to the quiet tragedies.
23 Let me give you a few examples. In 1999, Montana
24 charities received $360 million in contributions. The
25 Montana Food Bank in Missoula, Montana served 185,000

1 households in one year. They served 1,500,000 meals that
2 same year. They received over 600,000 pounds of
3 donations.
4 The United Way of Missoula County recently surpassed
5 their fundraising goal for 2001-2002 of $1.15 million.
6 They use these funds for a variety of services: providing
7 health services, youth services, family services, housing
8 services, and senior services.
9 Total giving to the University of Montana Foundation
10 totaled $21 million. This surpassed the 5-year average
11 of $15 million.
12 Groups like the Blackfoot Challenge provide local,
13 voluntary solutions to important environmental problems,
14 like restoring stream habitat. The list goes on.
15 People working in shelters, in churches, in
16 libraries, Scout troops, schools, boys and girls clubs,
17 substance abuse centers, jails, all across our
18 communities, all across our country.
19 This bill is designed to help these folks by creating
20 a few more incentives to encourage more contributions to
21 charity.
22 Let me briefly describe the main provisions of the
23 bill.
24 The provision that has received the most attention is
25 the above-the-line deduction for charitable contributions

1 for people who do not itemize their deductions.
2 Let us be honest here. I have some concerns this
3 provision. We have tried this approach before and it did
4 not work well. That is why we eliminated the deduction
5 in 1986.
6 More specifically, I am concerned that the deduction
7 will not provide much incentive for the charitable giving
8 and will make the Tax Code more complex.
9 Nonetheless, President Bush has made this particular
10 proposal his top priority. In light of that, we should
11 give the proposal a chance. At the same time, we limit
12 the proposal to two years so that we can carefully study
13 how well it is working.
14 While the non-itemizer deduction has received most of
15 the attention, there are several other provisions in the
16 bill that have strong bipartisan support and will provide
17 a significant boost to charitable giving.
18 We provide enhanced deductions for contributions of
19 food, books, computers, and bonds. As a result, for
20 example, we make it easier for a farmer to receive a fair
21 deduction for giving food to a local food bank, and for a
22 publisher to donate extra books to a local library.
23 We expand the IRA roll-over exceptions to allow
24 individuals to donate their IRAs to charity without
25 taking a tax hit. And we provide several important new

1 incentive for voluntary conservation, such as by
2 contributions of conservation easements, which are so
3 important to protect open space in America.
4 These are the highlights. There are other important
5 provisions. All told, this package includes many
6 proposals sponsored by members of the committee and
7 previously supported in the Senate.
8 We have also consulted closely with the
9 administration and with the lead sponsors of the main
10 Senate bill, Senators Lieberman and Santorum.
11 That covers the charitable provisions of the bill.
12 Let me now turn to the others.
13 To cover the cost of our mark, we have included two
14 proposals that Senator Grassley and I introduced earlier
15 this year. The first proposal goes after the
16 proliferation of abusive tax shelters.
17 I introduced the Tax Shelter Transparency Act with
18 Senator Grassley to encourage more timely and accurate
19 disclosure of these abusive transactions. Under the
20 proposal, promoters, advisors, and taxpayers will be
21 subject to stiff penalties for failing to acknowledge
22 these transactions to the IRS.
23 The mark also includes our legislation to address the
24 growing practice of corporate inversions. Many American
25 companies have engaged in, or are thinking about,

1 relocating their corporate headquarters in tax haven
2 countries as a tax dodge.
3 The Reversing the Expatriation of Profits Offshore
4 Act, otherwise known as the REPO Act, eliminates the
5 loophole in the Tax Code that lets a corporation with
6 nothing more than a file folder or a post office box in a
7 tax haven country escape millions in U.S. taxes.
8 It just is not right when a majority of taxpayers,
9 for example, the hardware store owners in Butte, or the
10 local store in Dubuque, Iowa, pay their fair share of
11 taxes while these big corporations twist their way out of
12 paying their own fair share. It is simply wrong.
13 But it is the right thing to do to use these
14 proposals to pay for tax incentives to benefit the
15 charitable community. It is the right thing to do, and
16 it is the right time to do it.
17 I would like to conclude by thanking my good friend,
18 Senator Grassley, for his help in putting this
19 compromise, this bipartisan legislation, together. I
20 look forward to working with him and members of the
21 committee to see it enacted into law.
22 I would now like to turn to the Ranking Member of the
23 committee, Senator Grassley.
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1 OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S.
2 SENATOR FROM IOWA
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4 Senator Grassley. Yes. I will start where you left
5 off by saying hat this continues the tradition of
6 bipartisanship on this committee, and I thank you for
7 that. Particularly, it has been so in the area of tax
8 matters.
9 Encouraging a greater role for charities in the
10 fabric of our Nation has been a very strong priority for
11 our President. The American people certainly agree with
12 the President that charities are a vital part of our
13 country's tradition. The tragedy of September 11th saw
14 an enormous outpouring of giving to charities to help
15 those in need.
16 The bill before us provides for fairer tax treatment
17 for individuals who donate individual retirement accounts
18 to charities. The bill has provisions to encourage
19 donation of food that will help many Americans who are in
20 need.
21 This bill contains several changes that will
22 encourage conservation and preservation of land, helping
23 our Nation's environment.
24 But I would like to spend some time on two other
25 pieces of legislation, the inversion proposal and the tax

1 shelter proposal.
2 Mr. Chairman, my preference was that we move
3 legislation without offsets. That position is consistent
4 with the President's budget. Also, I view many of the
5 offsets as good tax policy, not just as revenue raisers.
6 On a solid bipartisan basis, however, our committee
7 members told us as leaders that they wanted offsets in
8 this CARE Act. You agreed to proceed, then, Mr.
9 Chairman, on two tracks. So today we will approve these
10 policies, as I prefer, in stand-alone matter as well as
11 offsets.
12 The Chairman's mark includes our bill he referred to,
13 the Reversing the Expatriation of Profits Offshore. This
14 bill stems corporate inversions where U.S. companies
15 create fictional headquarters in a tax haven to escape
16 U.S. taxes. These fictional headquarters are no more
17 than a folder in a filing cabinet overseas.
18 Let me say, first, that I have no problem with any
19 U.S. company operating in a low-tax jurisdiction for
20 legitimate business purposes. Companies from other
21 countries do this, and U.S. companies must be allowed to
22 compete.
23 However, there is a world of difference between a
24 U.S. company operating in a low-tax country for valid
25 business reasons and a phony tax haven headquarter.

1 The recent spate of inversion deals could not be done
2 if it were not for two things. One, net operating losses
3 have built up during the recession. Those losses are
4 used to shield the corporation from tax when it transfers
5 its paper assets to the haven country.
6 Two, it is more troubling that, to make these deals
7 work, you must have a depressed stock market. A
8 depressed stock market reduces the tax on shareholders
9 who approve these deals.
10 Now, this is nothing new. For years, U.S. insurance
11 companies have been fleeing to Bermuda to eliminate U.S.
12 tax on their investment and gain a huge advantage over
13 U.S.-based insurers.
14 That is why we have included a provision that will
15 enhance Treasury's ability to reduce related-party
16 reinsurance schemes that strip income out of the United
17 States' tax base and park it offshore, tax-free.
18 While I am firmly committed to holding corporate
19 inversions, I also recognize that the rising tide of
20 corporation expatriations demonstrates that our
21 international tax rules are deeply flawed, undermining an
22 American company's ability to compete in the global
23 marketplace.
24 I believe that we need to bring our international tax
25 system in line with our open market trade policies. I

1 want to make it clear, once again, that reform of our
2 international tax laws is necessary for U.S. businesses
3 to remain competitive in our global marketplace.
4 Mr. Chairman, now more than ever an anti-competitive
5 tax policy translates into the loss of jobs here in
6 America; foreign tax credit, Subpart F, and other sets of
7 rules are no longer board room abstractions.
8 Moreover, the U.S. companies that rejected doing a
9 corporate inversion, those that stayed in America and
10 stayed glued to the cause of America economically and
11 politically are left to struggle with the complexity and
12 competitive impediments of our international tax rules.
13 This is an unjust result for companies that chose to
14 remain in the United States. I am committed to remedying
15 the inequity.
16 This committee is fortunate to have two leaders in
17 the area of international tax reform, Chairman Baucus and
18 Senator Hatch. For many years, they have co-sponsored
19 international tax simplification bills.
20 I had hoped that our inversion bill could be used as
21 a down payment to implement some of these reforms which
22 would remove some of the unfairness imposed on these
23 companies that "stay and pay" in America rather than
24 "dash and stash."
25 But I am, nonetheless, glad to see the REPO bill move

1 any way that it can. We need to get inversions shut down
2 quickly. So, I commend the Chairman for including this.
3 Let me also commend the administration on this
4 inversion work. In many ways, the administration's study
5 and ultimate proposals aim at the heart of the problem.
6 Our efforts today are meant to complement, obviously not
7 conflict with, the administration's broader approach.
8 The inversion bill is a temporary response to an
9 immediate tax policy concern. The administration's
10 approach looks to the long-term consequences of yet a
11 deeper problem.
12 Finally, let us turn to the tax shelter curtailment
13 measures. I am also pleased that the Chairman's mark
14 includes his bill, the Tax Shelter Transparency Act. It
15 is surprising and unfortunate that taxpayers, though
16 required to disclose tax shelter transactions, under
17 present law have refused to comply.
18 A mere 272 tax shelter return disclosures from only
19 99 corporate taxpayers were received, a fraction of those
20 that require such disclosure.
21 There is evidence that taxpayers will disclose their
22 transactions when given an opportunity to avoid
23 significant penalties. The Office of Tax Shelter
24 Analysis recently offered to waive 20 percent under-
25 statement penalty if taxpayers voluntarily disclosed.

1 The response was overwhelming. Nearly 1,000 abusive
2 tax avoidance transaction disclosed 1,341 illicit tax
3 shelter transactions, a bonanza of new information.
4 So Senator Baucus' bill has been carefully structured
5 to reward those who are forthcoming with disclosure. It
6 will curb non-compliance by providing clearer and more
7 objective rules for the reporting of potential tax
8 shelters. It also provides strict and substantial
9 penalty for anyone who refuses to comply.
10 Transparency is essential to an evaluation by the
11 IRS, and ultimately by the Congress, as to whether tax
12 benefits generated by complex business transactions are
13 appropriate interpretations of existing law.
14 As with inversions, the administration has stepped up
15 to the plate. Much of the Chairman's mark is derived
16 from Treasury's proposals to curtail such shelter
17 activity. I am pleased that the Treasury partnered with
18 Finance Committee members and staff on the project.
19 Today, we will move the ball forward, arm in arm with the
20 administration. I expect this bipartisan approach to
21 soon become bicameral.
22 So, Mr. Chairman, summing up, I am pleased that we
23 will act on three initiatives today: the CARE Act, an
24 important priority of President Bush; and the two others,
25 inversions and tax shelter curtailment, that are

1 important tax policy priorities that members of this
2 committee and the administration agree need to be
3 addressed.
4 Thank you.
5 The Chairman. Thank you very much, Senator.
6 We will now proceed to statements by other members of
7 the committee. I remind my colleagues that, under the
8 committee rules, we need nine Senators to transact
9 business--that means adopt amendments--and 11 present
10 physically present, to report out legislation.
11 So, I would encourage my colleagues to be short so we
12 can get down to business and have enough Senators present
13 to conduct business.
14 According to the early bird rule, next on the list is
15 Senator Bingaman.
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1 OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR
2 FROM NEW MEXICO
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4 Senator Bingaman. Thank you very much, Mr.
5 Chairman.
6 I have two major concerns with what we are getting
7 ready to do here. One, is that I have been frustrated
8 that there are a lot of pieces of legislation in the
9 committee that have been referred here on other issues
10 than this, some even non-tax issues that we have not been
11 able to find time to deal with.
12 I have filed a couple of amendments to this that are
13 unrelated, just out of frustration, not knowing how we
14 can finally hope to get those enacted in this Congress.
15 One relates to pregnant women coverage under the CHPs
16 program. Now, this is a provision which, I understand,
17 does not relate to the bill that you are trying to mark
18 up here, but it is one that does have the support or co-
19 sponsorship of Senators Breaux, Daschle, Graham, Kerry,
20 Lincoln, Lott, Rockefeller, Snowe, and Torricelli. So,
21 there is good support on our committee for it.
22 I would hope, sometime, either later this month or
23 before the August recess, we could either do legislation
24 that deals with health care issues and add that to it or
25 do our reauthorization of the TANF legislation and have a

1 chance to include that.

2 One way or another, I think that to my mind that is a
3 higher priority for my constituents than what we are
4 attempting to do today, although there are some decent
5 provisions in this bill which I could support under other
6 circumstances.

7 I do not know if the Chairman can give us any
8 indication as to when you might think the committee would
9 consider either TANF reauthorization or health care-
10 related legislation. Do we think we will do that before
11 August, or do we know?

12 The Chairman. Well, Senator, you make a very good
13 point. The legislation you referred to is vital, it is
14 important. It is a priority of mine. It is my intent to
15 bring up both the provision you mentioned and the Family
16 Opportunity Act before the July 4th recess. That would
17 be a good opportunity to move that forward.

18 We do have a fairly full schedule this month. It is
19 going to be a bit difficult. But, nevertheless, that is
20 my intention.

21 Senator Bingaman. Well, I appreciate hearing that.
22 I do think it is important that we try, since we have so
23 many things competing for the committee's time and we
24 have got 10 or 11 weeks left before the Congress
25 adjourns, according to my calculations, of actual work

1 time, I think it is very important that we prioritize
2 those.
3 On the bill that you are trying to mark up, my
4 concern--and maybe I could ask one or two of the
5 witnesses a question on this. Or maybe that is not
6 appropriate at this point.
7 The Chairman. If you could wait a second, Senator.
8 Senator Bingaman. All right. Well, let me just
9 state my concern then, if we get to questions.
10 My concern is, it is still not paid for. As I
11 understand it, we do have the two provisions you have
12 talked about. We also have the main source of revenue
13 that we are putting forward to pay for this, which is the
14 various Customs fees, again. They are Customs user fees,
15 IRS fees.
16 It is my understanding that those are not considered
17 revenue under the budget rules, that this bill, if it
18 comes to the floor, will be subject to a 60 vote point of
19 order because of that.
20 It is also my understanding that we have already used
21 these Customs user fees two other times in this Congress.
22 Sooner or later--
23 The Chairman. Is that all? [Laughter].
24 Senator Bingaman. This is the traditional, "trot
25 out the usual suspects when you need an offset.".

1 Senator Gramm. You wear a tie more than once.
2 [Laughter].
3 Senator Bingaman. That is true. You do wear a tie
4 more than once. That is correct.
5 I think, Mr. Chairman, we have passed about $1.4
6 trillion in tax cuts so far in this Congress. I think it
7 is getting irresponsible for us to keep passing more and
8 more without offsetting them. That is essentially what
9 we are being asked to do today.
10 The Chairman. Let me get to those points when we
11 get to the explanation of the bill.
12 Senator Bingaman. All right.
13 The Chairman. Thank you.
14 Next in line is Senator Gramm, for any statement you
15 might want to make before we get to explanation.
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1 OPENING STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM
2 TEXAS
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4 Senator Gramm. First of all, Mr. Chairman, let me
5 say that I think, overall, there are some good things in
6 the bill. I want to commend you for dropping this silly
7 business where you put $500 in an account, and then
8 people give you $500. I just do not think that every met
9 the "laugh test." I want to congratulate you for
10 dropping it, and I want to urge you not to let it be
11 reattached to this bill.
12 There are a couple of areas of the bill that concern
13 me. One, is this area where, when you are dealing with
14 conservation, most of these conservation groups are tax-
15 exempt, so when you give them something you get the same
16 treatment you get when you give it to the church. But it
17 is my understanding, in looking at the language of your
18 bill, that you also add a 25 percent exclusion on the
19 capital gain.
20 What that would mean, is you are setting conservation
21 at a higher priority than anything else in American
22 society in terms of the Tax Code. It seems to me that we
23 are going to have to do one of two things before the
24 debate is over. Either we are going to have to drop this
25 provision, or we are going to have to give it to

1 everybody.

2 I would just urge you to look at it. I do not think
3 it is a sustainable position to say that, if I try to
4 give my land to my children, I do not get any tax break.
5 If I give it to the church, I get to deduct it as a
6 charitable contribution and take it as a deduction.

7 If I give it to a conservation group, I get to take
8 the deduction and I get a 25 percent exclusion on my
9 capital gains. I just do not think that is sustainable.
10 I know some people love conservation, but that takes love
11 beyond reason. It is love with reason we are looking
12 for.

13 So, if I am right about this--and I think I am, all I
14 have done is just read your language--I do not think this
15 is going to hold up. I think you are going to get a
16 series of amendments saying, well, give it to everybody.
17 If you do not want to do that, the best thing to do would
18 be to drop it.

19 The second thing I want to raise, is I am a little
20 bit concerned about this loosening up on grassroots
21 lobbying. I think if there is anything that bugs people,
22 it is for people to be engaged in political activity at
23 the taxpayers' expense.

24 I commend political activity. I think, in a
25 democratic society, it is rendering unto Caesar, and I am

1 for it. But I think you ought to do it at your own
2 expense. I am a little bit nervous about the provision
3 of this bill that loosens up on the ability of these tax-
4 exempt organizations to engage in so-called grassroots
5 lobbying. I think we ought to leave that alone.
6 Finally, maybe this is blasphemy, but it makes me
7 nervous when we are changing the tax laws to let non-
8 profits go into business in competition with the private
9 sector when they are tax-exempt. We have got a provision
10 in here on passive income exclusion for unrelated
11 business income.
12 I am just concerned that we are going to get into a
13 situation where we are going to have nonprofits and
14 churches that are going to be in the rent business and
15 you are going to have people trying to compete that are
16 paying taxes with people that are not paying taxes.
17 I do not think a church is a business. If they want
18 to provide things and give them away, I think that is
19 great. But providing them and selling them and not
20 paying taxes, I do not think is great. So I think,
21 overall, I want to commend you.
22 I think there are some good things in the bill, but I
23 do think we have got a problem in these three areas. I
24 think we have got to decide, if we want to give
25 conservation this, there is no way, by the time we vote

1 on 10 or 15 different little heartburn things, to
2 crippled children, disabled veterans, and all that stuff,
3 we are going to end up giving this 25 percent exclusion
4 to everybody or taking it away from conservation. I urge
5 people to look at this deal about excluding passive
6 income for these nonprofits.
7 This grassroots lobbying business. I think that is
8 dangerous business. I think you start undercutting the
9 support for tax-exempt organizations when you make it
10 easier for them to lobby at the taxpayers' expense.
11 So, I would just point out those three things. In a
12 big bill, these are pretty small things, but they are
13 three things I think we ought to do.
14 The Chairman. Thank you, Senator.
15 Senator Breaux?
16 Senator Breaux. Mr. Chairman, I support the mark.
17 Let us move on.
18 The Chairman. Senator Thompson?
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1 OPENING STATEMENT OF HON. FRED THOMPSON, A U.S. SENATOR
2 FROM TENNESSEE
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4 Senator Thompson. Mr. Chairman, I, on balance
5 support the charitable contribution provision. I guess I
6 feel somewhat like you do, and Senator Grassley. There
7 are some legitimate concerns about it, but I appreciate
8 your recognizing the President's priority on this, and I
9 think it probably ought to be given an opportunity.
10 I do have concern over the fact that we seem to
11 consistently do two things in the U.S. Congress. That
12 is, one, talk about tax simplification, and two, continue
13 to complicate the Tax Code. This is just another step in
14 that direction, and moving away from 1986. I long for
15 the day when maybe that can be changed and go back in the
16 other direction.
17 On the inversion issue, that is a complex issue or
18 set of issues there, Mr. Chairman. I think what we are
19 seeing is something that is a sign of the underlying
20 flaws in the U.S. corporate tax regime. I would like to
21 see us have some discussion about the root cause of these
22 inversions and what we ought to be doing about it.
23 As far as I know, we have not had a hearing dedicated
24 to the issue of inversions. It is hard to imagine taking
25 action like this. It is something that has been going on

1 for some time. I realize that economic conditions and
2 all make it more popular today. But we are rushing right
3 into the middle of something where the Treasury has not
4 made a recommendation yet on that. So, I think we are
5 really jumping the gun on that provision.
6 So, I hope that this is not the end of the debate on
7 inversions--I am sure that it will not be--but rather the
8 beginning of a serious debate on our foreign tax system
9 and its impact on the competitiveness of U.S.-based
10 multinational corporations.
11 I understand that some in the House favor a temporary
12 moratorium while we get our arms around this a little
13 better. To me, that seems to make a lot more sense, and
14 perhaps that is where we will wind up.
15 Thank you, Mr. Chairman.
16 The Chairman. Thank you very much, Senator.
17 Next, Senator Kyl.
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1 OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM
2 ARIZONA
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4 Senator Kyl. Thank you, Mr. Chairman. First, let
5 me associate myself with the remarks of both Senator
6 Gramm from Texas and Senator Thompson. I agree that it
7 is important for the committee, recognizing the
8 President's priority here, to deal with this. I commend
9 you, Mr. Chairman, for doing exactly that.
10 And there are some laudable things in the bill, but
11 I, too, believe that there are some problems with the
12 bill that we really ought to deal with, and I am hoping
13 we can deal with some of them here. Some, perhaps, will
14 have to be dealt with on the floor.
15 But the bill spends too much, particularly relative
16 to any reasonable expectation of benefits in terms of
17 enhanced charitable giving. We have pilot projects, for
18 example, that are under way that we have not waited for
19 the results of before some people have proposed expanding
20 the concepts. I am glad we took the IDA savings account
21 out of the mark, and I agree with Senator Gramm that that
22 cannot be included in the bill.
23 Another area that I am concerned about, is the
24 deduction for non-itemizers. The reason there is a
25 standard deduction, is because we recognized about how

1 much non-itemizers give to charities and provide a
2 standard deduction to accommodate precisely that. I do
3 not think there is any evidence that adding another
4 deduction on top of that is going to enhance the giving
5 by those people.
6 Despite the complexity of the provisions designed to
7 eliminate fraud, I am also concerned about the
8 possibility of the administration of that particular
9 section.
10 I also think the bill, to some extent, misses
11 opportunities. I plan to offer an amendment dealing with
12 charitable giving to education. I have been urging this
13 now for over a year. We have not been able to even get a
14 hearing on the subject, and I think it is time that we
15 deal with that subject.
16 Finally, I agree with Senator Bingaman. The Customs'
17 user fee is a tie we have worn out. This would be the
18 third time now to pay for something. The expression we
19 have out in Arizona, is you have already sold that pony
20 twice already, and now we are going to sell it again.
21 So, that pony is going to get pretty worn out serving
22 three masters 100 percent of the time. It ought to be
23 used for Customs.
24 The language of the bill itself specifically says it
25 will be used for Customs. I mean, that is the irony. So

1 it cannot be a pay-for, as a practical matter, if we say
2 that Customs user fees will only be used for Customs
3 purposes.
4 Under the obscure rules of scoring, any revenue
5 raiser can be designed as a pay-for. But as a practical,
6 real matter, the money could never be a pay-for because
7 of the language that we have here and the fact that it
8 has already been earmarked in other legislation.
9 So if we do not deal with that in some way here, I am
10 going to make sure that we deal with it on the floor so
11 that we are at least honest in our approach to this.
12 I am ambivalent at this point about the issue of pay-
13 for, but I at least think we have to be honest about not
14 suggesting that we are paying for something when, in
15 point of fact, we all know the money has already been
16 spoken for.
17 Thank you, Mr. Chairman.
18 The Chairman. Thank you, Senator.
19 Senator Thomas?
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1 OPENING STATEMENT OF HON. CRAIG THOMAS, A U.S. SENATOR
2 FROM WYOMING
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4 Senator Thomas. You will not be surprised to know I
5 will be a little repetitious, but I will try and be
6 short.
7 I am very pleased that we have moved to do something,
8 and thank you and thank the Ranking Member for putting
9 forth something on the President's initiative. I think
10 it is important, and base programs and so on need to be
11 pushed, and I am happy for that.
12 However, I am not sure this bill deals with the
13 underlying policy as proposed by the President. Rather,
14 we are considering, it seems to me, a package of
15 incentives that makes the President's faith-based and
16 community initiative sort of a minor part of a broader
17 bill. There are lots of things in it that are good.
18 Hopefully we can come out of it.
19 In general terms, I just have to say, as has already
20 been said, I think that we have been on a spending binge
21 here and we really have to do something about it. I am
22 not at all persuaded that these offsets are, indeed,
23 offsets. We talk about making tax policy less
24 complicated. This goes in the opposite direction of
25 that.

1 I am not sure that the changes from this are going to
2 cause many changes in charitable services for the needy.
3 But, in any event, I hope we can move forward with some
4 of the things that are useful, and I look forward to
5 that.
6 The Chairman. All right. Thank you, Senator, very
7 much.
8 Senator Gramm from Florida?
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1 OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM
2 FLORIDA
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4 Senator Graham. Thank you, Mr. Chairman. I also
5 extent my congratulations to you and Senator Grassley for
6 having brought us to this point today. I support
7 strongly the principle that there is a value to society
8 by encouraging non-governmental organizations to deliver
9 a variety of services to our people.
10 I have had many personal experiences working with
11 these type of organizations and have seen firsthand the
12 positive effects that they have on the lives of citizens
13 with a variety of problems. So, I support the basic
14 bill.
15 I am concerned about a couple of issues that have
16 been married to this bill. One, is the question of the
17 inversions and tax shelters issue. We need to deal with
18 that question, and this appears to be as an appropriate
19 place to do so as possible.
20 My questions will be whether we have adequately
21 diagnosed, based on what has been a historically
22 phenomenal period of corporate tax abuses, what the
23 central nature of those abuses are, and are we properly
24 dealing with them.
25 I am concerned that this may be our one and only

1 chance to do so, and if we fail to properly diagnose the
2 essential problem we will miss the opportunity to
3 prescribe an appropriate solution.
4 I also share the concerns that Senator Thompson and
5 others have raised about tax simplification, and that we
6 are, in this bill, going to add another layer of
7 complexity to our Tax Code.
8 So, I would hope that we would do something in this
9 process to begin to indicate the seriousness of our
10 intention to deal with that complexity, and I will be
11 suggesting a mechanism to do so in hopes that something
12 will emerge from this that will get us started on a
13 serious path towards looking at the Tax Code from the
14 perspective of its excessive complexity.
15 The Chairman. Thank you, Senator.
16 Senator Hatch?
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1 OPENING STATEMENT OF HON. ORRIN G. HATCH, A. U.S. SENATOR
2 FROM UTAH
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4 Senator Hatch. Thank you, Mr. Chairman. Thank you
5 for holding this meeting today, Mr. Chairman, on the CARE
6 Act, a bill that would encourage Americans to donate
7 generously to the charity of their choice.
8 In the wake of September 11th, Americans gave
9 billions of dollars to a wide variety of charities to
10 assist families of victims of those murderous attacks on
11 our Nation.
12 Our citizens have also contributed to charities that
13 are working to give the people of Afghanistan a brighter,
14 more hopeful future. Through their generosity, Americans
15 have shown their true colors as a compassionate, caring
16 people.
17 Unfortunately, many charities have had a difficult
18 time raising money over the past few months as the
19 economy has remained somewhat weak and as donations that
20 would have gone to other worthy causes went towards the
21 September 11th relief.
22 Now, I hope that the Finance Committee can do its
23 part today to help America's charities to continue their
24 invaluable work. As you know, Mr. Chairman, this bill is
25 a priority for President Bush.

1 I am particularly pleased that you included a more
2 targeted deduction for non-itemizers. Now, this would
3 provide a much bigger incentive for Americans to donate
4 that marginal dollar, and also lower the cost of this
5 provision to the Treasury.
6 At the same time, Mr. Chairman, I have to say that I
7 am disappointed with the fact that the committee has
8 decided to partially offset this bill with the anti-
9 inversion legislation
10 You and I have worked together for years on proposals
11 to improve our Nation's decrepit and outmoded system of
12 taxing international income, and we both know that in the
13 coming months the Finance Committee is going to have to
14 tackle the difficult questions of extra-territorial
15 income and foreign sales corporations.
16 Along with you, I am upset that a growing number of
17 domestic corporations have used legal shenanigans to give
18 up their U.S. citizenship and move to Bermuda to save
19 taxes, and I am committed to reforming our tax system so
20 that this does not happen in the future.
21 But we should fix the real problem, not put a Band-
22 Aid on the system or the symptom itself. Our outdated
23 tax provisions have put many U.S. companies at a
24 competitive disadvantage.
25 If we are going to raise revenue by stopping

1 corporations from moving overseas, I believe that we
2 should spend that revenue to improve the tax system for
3 those companies that decide to stay in our country in the
4 United States. I hope we can work together, as we have
5 over the past several years, to find ways to address
6 these important issues.
7 Again, Mr. Chairman, I want to thank you for holding
8 this mark-up.
9 The Chairman. Thank you very much, Senator.
10 Now I would like to move to business. The first
11 order of business is the charitable bill. The Chairman's
12 mark is before the committee. There is also a
13 modification to the Chairman's mark, which is hereby
14 incorporated into the mark.
15 I would like Ms. Paull to briefly describe the
16 modification. I think many Senators have a pretty good
17 idea of what is in this bill, but you might, Ms. Paull,
18 just give us a little overview.
19 Ms. Paull. Thank you, Mr. Chairman, members of the
20 committee.
21 There is a description of the modification before you
22 that has the number 61-02 on it. There are six
23 provisions in the underlying mark that are being
24 modified, and five additional provisions being added on.
25 The first modification of the Chairman's mark is to

1 modify the deduction for food inventory. One of the
2 features in the Chairman's mark is being removed, which
3 has to do with the valuation of food inventory.
4 The second modification deals with the deduction for
5 book inventories and the modification provides a new
6 definition of fair market value.
7 The Chairman. Lindy, may I ask you, what document
8 are you working off of?
9 Ms. Paull. I am working off of this document that,
10 up in the top corner, it says JCX 61-02.
11 The Chairman. All right. I have it. Thank you.
12 Ms. Paull. All right.
13 The third modification is to the proposed deduction
14 for contributions of appreciated bonds. That provision
15 that is in the Chairman's mark is being deleted entirely
16 by the modification.
17 The fourth modification has two features to it that
18 modifies the inversion provisions of the bill. The first
19 modification, is to include Senator Graham's amendment
20 that requires inverting companies to provide information
21 to shareholders, partners, and the IRS with respect to
22 the inverted transaction.
23 The second provision modifies the underlying proposal
24 to address the issue of when a U.S. corporate group buys
25 or acquires some companies or assets from a group that

1 was part of the inversion transaction. This would make a
2 clarification to the underlying provisions to get it back
3 to what was intended by the original authors of the bill.
4 The next provision, basically 5 and 6 that you see
5 here, are the extension of the IRS user fees and Customs
6 user fees. The time for which they are extended is
7 shortened in the bill to extend them through the year
8 2007.
9 There is an additional modification that is described
10 under a new provision, but it is actually a modification
11 to the tax shelter provisions, that would clarify that
12 the reasoning of the recent case in the Rite Aid decision
13 would not be available to be used to invalidate other
14 consolidated return regulations.
15 With respect to the new provisions that are added to
16 the bill, the first one is an enhanced deduction for a
17 charitable contribution of literary, musical and
18 artistic, and scholarly compositions. A number of
19 members of the committee are interested in that
20 provision.
21 The second new provision is to modify the tax-exempt
22 bond rules so that bonds can be issued by certain of the
23 501(c)(3) organizations to acquire land and timber that
24 are subject to conservation restrictions and also be able
25 to service the bonds through the cutting of the timber

1 over some time period, over the life of the bonds.
2 There is a $2 billion cap on those bonds and they are
3 authorized for about three years and three months,
4 through the end of 2005.
5 The next provision is to provide a tax exemption for
6 State-created property and casualty insurance risk pools
7 that are dealing with wind, storm, hail, and fire damage,
8 and coverage is not otherwise available in the State.
9 The next provision is to conform to a 1984
10 grandfather, under the present law, for a certain
11 university fund, grandfathered from the arbitrage rules.
12 That grandfather specified a constitutional date for the
13 State. In 1969, the constitution was amended, so this
14 would update the date of the constitutional reference in
15 that present law grandfather.
16 The final item is to provide an increased
17 authorization. This is just an authorization. It is
18 subject to appropriations. For the grant program for
19 low-income taxpayer clinics, the authorization would be
20 increased to $10 million.
21 That concludes the summary of the modification.
22 The Chairman. Thank you.
23 I can tell by the comments and some of the questions
24 in some of the statements by members that there might be
25 some questions that the Senators may have of the staff.

1 This would be an appropriate time to ask those questions,
2 if anybody has any.
3 Senator Bingaman?
4 Senator Bingaman. Yes. Let me just ask, if you
5 leave out the IRS fees and the Customs fees, how much
6 revenue are we raising and how much tax relief are we
7 providing?
8 Ms. Paull. Well, it would require a little
9 computation here.
10 Mr. Sullivan. The revenue portion is about $3.6
11 billion and the total benefits being provided are about
12 $9.8 billion.
13 Senator Bingaman. Now, the $9.8 billion. I have
14 this spreadsheet that you passed out here. It says,
15 "Total of Charitable Giving Incentive Provisions, $10.089
16 billion." Then over on the next page, there is another,
17 "Restoration of Social Security Block Grant." That is
18 $1.375 billion. Do you add those two together?
19 Ms. Paull. Actually, Senator Bingaman, we have a
20 new table. This could be confusing. Usually we Xerox
21 these in green for the modification.
22 Are you looking at the table that--
23 Senator Bingaman. I am looking at the one that was
24 sitting here when I walked in.
25 Ms. Paull. All right. Well, there might be two

1 sitting there, unfortunately, because there is one for
2 the original Chairman's mark and then there is one for
3 the mark, as modified.
4 The one that is as modified that Russ was just
5 talking about has a number up in the righthand corner of
6 JCS 64-02. If you look at the bottom of page 2, you get
7 to the $9.8 billion total figure because some of the
8 deletions in the bill actually reduced the cost of the
9 underlying bill.
10 The Chairman. I do not know if Senators have 68-02.
11 I do not. Do have that, Senator?
12 Ms. Paull. It is 64-02.
13 The Chairman. Well, I have got 58, but I do not
14 have 64.
15 Senator Bingaman. I was just handed 64.
16 Ms. Paull. That is the problem.
17 The Chairman. I was just handed 64.
18 Senator Bingaman. Yes. One other question I had.
19 How much money is contemplated here that we are taking
20 from Social Security to encourage people to get married?
21 Am I confused? Is there not a provision in here that is
22 a block grant program to encourage marriage?
23 Senator Gramm. This is a tie provision. [Laughter].
24 Mr. Sullivan. Senator, this provision related to
25 Social Security has to do with the Social Security block

1 grant. It is a separate program for the States, where
2 the States have some discretion as to how they use their
3 money. You may be thinking about some of the provisions
4 that are also affiliated with the TANF debate. There are
5 some issues there. This one does not relate.
6 Senator Bingaman. I had though, when we had our
7 earlier meeting--maybe those are not in here any more--I
8 thought there was some discussion that there was a couple
9 hundred million that was going to be provided to do
10 training related to marriage. Am I confused on all of
11 that? Is that all TANF?
12 Dr. Fowler. Those provisions will come up in our
13 TANF mark-up.
14 Senator Bingaman. That is the TANF thing. All
15 right. I thought that was part of this. Thanks.
16 The Chairman. This is not TANF.
17 Other questions?
18 [No response]
19 The Chairman. Any amendments? Senator Hatch?
20 Senator Hatch. Mr. Chairman, I call up my amendment
21 number two. Now, this amendment, which I will not offer,
22 would add two widely-supported provisions to improve the
23 competitiveness of our international tax rules to make
24 U.S.-based multinational companies more competitive in
25 the global marketplace.

1 Now, I believe strongly that we should not be
2 addressing the problem of corporation inversions in
3 isolation. The underlying problem with these inversions
4 is the fact that our system of taxing multinational
5 companies has not kept up with the globalization of
6 business transactions.
7 In light of the growing trend of inversions and of
8 the pending issue of foreign sales corporations and the
9 WTO's ruling against the U.S. which this committee must
10 soon address, I hope I can get the Chairman's commitment
11 to hold hearings on this important issue very soon.
12 I also hope you will commit to join me again, as you
13 have in the past several Congresses, in introducing
14 bipartisan legislation to simplify our international tax
15 regime and address the anti-competitive aspects in both
16 the Subpart F and foreign tax rules.
17 The Chairman. Senator, you are very much on target.
18 Clearly, this question has arisen several times in the
19 conversation here in this committee, not only today but
20 in previous sessions, about how we, the United States,
21 are in a certain sense slipping behind other countries
22 with respect to our tax regime. Our foreign tax regime
23 must be updated and kept more current with what is
24 happening in the world.
25 Clearly, the FSC issue, and the WTO decision, is a

1 consequence of the mismatch between our two systems.
2 Frankly, I believe that WTO rules are unfair with respect
3 to the United States. Regrettably, our country, years
4 ago, agreed to WTO decisions which put our country in a
5 disadvantageous position compared with other countries.
6 That is the main reason why the WTO made that ruling
7 adverse to the United States, and why, if some changes
8 are not made, the Europeans claim they can retaliate to
9 the tune of $2 to 4 billion over the next period of time.
10 We have some breathing room with respect to the WTO
11 decision, but not much. We are going to have to move, as
12 a country to address that, not only from a tax point of
13 view, but also in the WTO forum. It is not going to be
14 easy, but, nevertheless, that is something we must do.
15 We are moving the inversion legislation today.
16 Senator Thompson made a good point, that we have not
17 really delved into it, dotted every "i" and crossed every
18 "t." It is true, we have not. You and I, Senator, many
19 times, introduced tax simplification legislation and I
20 followed your lead on that. You have done a very good
21 job.
22 It is my expectation to hold hearings. We should
23 hold hearings on international tax issues. We have an
24 obligation to do so, because there are so many different
25 sort of vectors, factors, that are kind of closing in on

1 us in a harmful way, which means we must get moving. I
2 think Senator Graham might even have an amendment to set
3 up a commission, an international taxation commission,
4 for us to look at these issues.
5 The main point is, you are right. We are going to
6 have hearings this year on international taxation
7 questions so that we can begin to solve this problem.
8 Senator Grassley. Mr. Chairman, I want to state for
9 the Republicans that I agree with your comments and look
10 forward to working with you and any other Senator,
11 including Senator Hatch, trying to find a solution to
12 this.
13 When I introduced the inversion bill I made very
14 clear that we need to bring our international tax system
15 in line with our open market trade policies. I believe
16 that reform of our international tax laws is necessary
17 for U.S. business to remain competitive in the global
18 marketplace.
19 Also, U.S. companies that rejected doing corporate
20 inversions are left to struggle with complexity and
21 competitive impediments of the international tax laws.
22 This is an unjust result for companies that choose to
23 remain here and pay their fair share of tax. I want both
24 Senators to know that I am committed to remedying this
25 inequity and look forward to working together in a

1 bipartisan effort of international tax reform, and also
2 welcome the hearings.
3 Senator Hatch. Well, I want to thank the Chairman
4 and the Ranking Republican for their comments and
5 commitments to this issue, which I think is of vital
6 importance to U.S. jobs and our own competitiveness. I
7 interpret that you will help work on legislation that can
8 be passed.
9 The Chairman. Absolutely. You bet. Absolutely.
10 Senator Hatch. Thank you.
11 The Chairman. Other amendments? Senator Breaux?
12 Senator Breaux. Thank you, Mr. Chairman.
13 Mr. Chairman, I have an amendment which would be
14 listed as Breaux Number 5. That amendment basically
15 deals with the question of private foundations
16 contributing scholarships to their employees or the
17 children of their employees of their company.
18 We are trying to increase the number of kids that
19 have an opportunity to go to college by encouraging
20 private foundations to be able to give more scholarships
21 than they currently can.
22 Under the current law, a private foundation, for
23 example, can only give scholarships to either 25 percent
24 of the applications that actually apply or 10 percent of
25 the eligible students who would be eligible to apply.

1 That is just an arbitrary number. I think it is very
2 restrictive.
3 The Internal Revenue Service has a very sophisticated
4 and very complicated 10 tests that have to be met in
5 order for a private foundation to be eligible to give any
6 scholarships to the children of their employees. The
7 reason is obvious, because you do not want scholarships
8 to be used to mask compensation which should be given and
9 should be subject to tax. But I think those 10 tests, if
10 applied properly, really ensure that no harm is being
11 done.
12 So what my amendment would do, very simply, is to
13 increase the 25 percent cap for applicants to 35 percent
14 and to 10 percent of eligible students to be increased to
15 20 percent of the eligible students. The same tests
16 would apply to make sure that it is being done properly.
17 That is my amendment.
18 The Chairman. Is there any discussion?
19 [No response]
20 The Chairman. I would like to ask Treasury its
21 views on this.
22 Ms. Olsen. We do not have a position on this at
23 this time. We would like to give it some further study
24 before taking a position. Specifically, we would like to
25 get some more information about why the percentage tests

1 that are included in the IRS revenue procedure right now
2 are too tight.
3 Senator Breaux. They are not too tight. I think
4 the tests are fine. I just want to raise the cap.
5 Ms. Olsen. The percentages. We would like to
6 understand why they are too low, and if there are other
7 things that we might be able to do through the
8 alternative facts and circumstances test that would
9 address this.
10 Senator Breaux. I mean, it is very simple. We are
11 raising it from 25 percent to 35 percent so they will be
12 able to give more scholarships. It is very simple.
13 The Chairman. I would ask Ms. Paull if she has any
14 Joint Tax views on this.
15 Ms. Paull. The estimate for this proposal is $132
16 million over 10 years. I think this just gets back to
17 the fundamentals of how you distinguish between what is a
18 compensatory type of a program versus a scholarship type
19 of a program.
20 Certainly, the way the rules are set up now, you do
21 not have to prove that it is a scholarship program, you
22 just rely on those 25 percent and 10 percent tests.
23 If you do not meet that test, if you want to do more,
24 you have to prove that it is a true scholarship program.
25 I think that is where there is a little--

1 Senator Breaux. That is not true. You have to meet
2 the 10 test even for the first 25 percent. Is that not
3 correct, Ms. Olsen? You cannot give any scholarship
4 without meeting the 10 test that you have.
5 Ms. Olsen. No, I do not think that is right. I
6 think there are alternative tests so you could still
7 satisfy the alternative test even if you were above the
8 10 and 25 percent limits.
9 Mr. Sullivan. Senator Breaux, you would have to
10 submit a private letter ruling request to the Service.
11 You could get that if you wanted to go above those
12 limits. That is the procedure, I think.
13 Senator Breaux. All right.
14 Ms. Paull. I am being told you have to meet some
15 basic-level tests for a program.
16 Senator Breaux. Sure.
17 Ms. Paull. And then this 25 percent, 10 percent,
18 are safe harbors. You submit a letter ruling request,
19 but you can go over that if you can prove that you have
20 the need for it.
21 And that is where I think there is a little
22 confusion, because you want to keep the program being
23 scholarship-oriented as opposed to benefit-oriented. I
24 do not know what the right levels are, myself, either.
25 Senator Breaux. The intent is to keep the same test

1 and the same standards and to merely increase the
2 percentage to allow people to give more scholarships to
3 encourage more people to go to college.
4 Senator Grassley. Mr. Chairman?
5 The Chairman. Senator Grassley?
6 Senator Grassley. I am concerned about the
7 amendment. I have had my staff of the Finance Committee
8 conducting an ongoing review of private foundations. The
9 review has found that, while many foundations do find
10 work, there are many that are falling far short of
11 providing real support to charities.
12 I think my concern is that the amendment might send a
13 message in the wrong direction. I think it would
14 encourage private foundations to more and more be a
15 vehicle for basically compensation for employees, and we
16 need foundations to be really what they were intended to
17 be, a charitable business.
18 I believe we ought to question that the American
19 taxpayers should be footing a bill of millions of dollars
20 so that corporate America can provide benefits to their
21 employees.
22 As Mr. Sullivan noted, there can be a private letter
23 ruling. There are revenue procedures to provide some
24 relief for what Senator Breaux is asking for. The system
25 has worked well and allows the IRS to apply a facts and

1 circumstance test.

2 We have safe harbor, and procedures for foundations

3 to appeal for guidance beyond the safe harbor. It is a

4 system that I think has worked pretty successfully for

5 years, and I question whether this would be a wise change

6 and have the Senate fixing a problem that does not exist.

7 Further discussion?

8 [No response]

9 The Chairman. As I understand it, the intent of the

10 author is to keep the same requirements that encourage

11 these contributions to be in the nature of charitable

12 transactions as opposed to compensation to employees, but

13 that he is raising the amount that can be given under

14 this program, keeping the same standards, assuring that

15 the nature of the contribution is not compensation, but

16 is charitable giving. That is my understanding.

17 Senator Breaux. The Chairman is correct. I mean,

18 the only thing we are doing is having the same system in

19 place, but just increasing the percentage of eligible

20 kids that would have the opportunity to get a college

21 scholarship from a private foundation. How in the world

22 this encourages any kind of mischief from a private

23 foundation, I do not know.

24 It is limited to college scholarships for children

25 going to college and it merely raises, by a small amount,

1 the amount that they can give to eligible students to go
2 to college.
3 The tests that they would have to meet would be
4 exactly the same test. This encourages more kids to be
5 able to go to college through a contribution from a
6 private foundation.
7 The Chairman. Well, I suggest we take this
8 amendment and work out, between now and the floor,
9 problems that some Senators have raised to address them.
10 That is my suggestion.
11 Senator Nickles. Mr. Chairman?
12 The Chairman. Senator Nickles?
13 Senator Nickles. I am missing a little something.
14 You are talking about charitable foundations?
15 Senator Breaux. Private foundations.
16 Senator Nickles. Private foundations. So, assuming
17 it is a corporate set-up, they have already got the
18 deduction setting up the foundation. So now that the
19 foundation has X number of dollars, Senator Breaux's
20 amendment is that they should be able to give a greater
21 percentage of those dollars to scholarships.
22 Now, the cost of the amendment, Lindy, I think you
23 said, was like $100 some million.
24 Ms. Paull. It is $132 million.
25 Senator Nickles. But if they do not give it to

1 students, they are going to give it someplace else.

2 Senator Breaux. Exactly right.

3 Senator Nickles. I do not see where the cost is. I
4 am missing something. They have already gotten the
5 deduction when they set up the foundation.

6 Mr. Zerbe. Senator, I think the concern is that the
7 scholarships are not going just to the general public,
8 they are going to employees of the corporation. I think
9 the concern may be that it is a hidden benefit to the
10 employees and that other corporations will, thus, also
11 take advantage of this and set up similar programs.

12 The limits he is referring to are those limits that
13 are put in place where the percentages of employees of
14 the corporation that are involved, I think the score is
15 probably reflecting a concern that similarly situated
16 corporations will also create programs that will provide
17 what is viewed by some as a benefit to their employees.

18 Senator Breaux. If the Senator would yield on that.
19 I mean, one of the specific tests that they have to meet
20 is that the scholarship program is not used to defer
21 compensation. I mean, that is one of the things they
22 have to show to the IRS, is that they do not use this as
23 a recruitment tool or that it is not being used to
24 replace compensation.

25 That is the existing rule at the percentage it is

1 now. It would still have to show that it is not being
2 used to avoid compensation for employees. That does not
3 change one iota. Is that not right?
4 Mr. Zerbe. Yes, Senator.
5 Ms. Paull. Back to Senator Nickles' question.
6 Also, in addition to what Dean just mentioned to you, the
7 revenue estimate also takes into effect that there would
8 be more excludable scholarship money in the system,
9 because scholarships and fellowships under Section 117
10 are excludable from income.
11 Senator Nickles. I did not quite understand that.
12 Ms. Paull. To the recipient.
13 Senator Nickles. So you are assuming that there
14 will be more scholarships. The foundation has already
15 got the deduction, but there would be more scholarships,
16 and therefore people will have--
17 Ms. Paull. So that scholarship is not taxable,
18 whereas, if they make a different kind of a grant and it
19 does not fit within the scholarship categories, it would
20 be taxable to people.
21 Senator Nickles. I am just wondering. When I ran
22 our company, we set up a little scholarship program. We
23 did not do it through a foundation, we just expensed it.
24 We just handed out some money. Was that legal, or should
25 I be in jail? [Laughter].

1 Ms. Paull. Well, you provided a benefit to the
2 employees of your company.
3 Senator Gramm. He knows the statute on that.
4 [Laughter].
5 The Chairman. Any further discussion?
6 Senator Grassley. If we are going to accept this, I
7 hope that we would get the cooperation of any of the
8 charities that are involved, and foundations that are
9 involved, to have us get our questions answered.
10 The Chairman. I think that is a good idea.
11 Senator Nickles. Could I ask another question?
12 Senator Grassley. So would Senator Breaux
13 facilitate that for us?
14 Senator Breaux. Of course.
15 Senator Nickles. If you had a private corporation,
16 they set up a foundation, the foundation has a lot of
17 charitable purposes and scholarships may be one of many.
18 It may be foundations do a lot of things to benefit the
19 community, but part of that would be scholarships. Right
20 now, it would be limited to 10 percent and you would want
21 to increase that to 25?
22 Ms. Paull. Twenty.
23 Senator Breaux. Twenty percent. They can give it
24 to anybody. The only cap applies to employees.
25 Ms. Paull. Or the child of an employee.

1 Senator Nickles. So if you have a large foundation-
2 -Bill Gates has a foundation and he gives a lot of money
3 to lots of charities, and I am assuming part of that is
4 in scholarships. Does this mean that a certain
5 percentage of Microsoft employees would all be eligible
6 for tax-free scholarships, a higher percentage? Is this
7 where the revenue loss is?
8 Ms. Paull. I think the answer is yes. I do not
9 know the Gates Foundation facts.
10 Senator Nickles. Well, I should not use just one.
11 But a large foundation. There are lots of foundations.
12 I will leave that name off.
13 Ms. Paull. All right.
14 Senator Nickles. But they could give just solely
15 for that company. Is the Senator's amendment just
16 related to the company?
17 Ms. Paull. These limits only apply to the employees
18 and the children of the employees of the company that are
19 related to the foundation.
20 Senator Breaux. In other words, there is no limit
21 to what they can give to non-employees' children.
22 Senator Nickles. All right. I follow you, now.
23 Mr. Zerbe. Yes, Senator. There is no limit. If
24 they wanted to do nothing but give out scholarships to
25 people other than their employees, they could do so.

1 Senator Nickles. But this limitation is just for
2 company-related individuals.
3 Senator Breaux. Yes. That is correct.
4 The Chairman. Senator Gramm?
5 Senator Gramm. Mr. Chairman, I do not have strong
6 feelings about this, but if I now understand it, I do not
7 think we have done a good job explaining it. The point
8 is, you set up a foundation, you are giving away the
9 money tax-free to the person who is the beneficiary.
10 We have a 10 percent cap on the amount you can give
11 your own employees to try to prevent companies from using
12 the foundation to provide tax-free income for their
13 employees as a way, in essence, of giving wages that are
14 not taxable. When you raise that amount, you create a
15 situation where companies are able to do more of that.
16 Now, Senator Breaux says, you are not going to let
17 them use it in recruitment. But how can it not be? If I
18 have got a choice between two companies and I am a
19 college student, and one of them pays college tuition and
20 one does not, how can it not be a factor?
21 So, I do not have any strong feelings about it. I
22 just think the question you have got to ask is, is this
23 going to be abused as companies try to use it to give
24 tax-free income?
25 The Chairman. I think the question is raised. Let

1 us work on those questions between now and the floor.

2 I am going to ask for a vote. Very quickly, Senator

3 Kyl?

4 Senator Kyl. Mr. Chairman, I had the cousin

5 amendment to this that I would like to propose.

6 The Chairman. Well, we have to dispose of this

7 amendment.

8 All those in favor vote aye.

9 [A chorus of ayes]

10 The Chairman. Those opposed, no.

11 [A chorus of nays]

12 The Chairman. The ayes have it. The amendment is

13 agreed to.

14 Senator Gramm?

15 Senator Gramm. Mr. Chairman, I wanted to offer an

16 amendment to strike the 25 percent exclusion for the

17 sales made for qualified conservation purposes. Let me

18 explain this amendment, if I can.

19 When I was speaking a minute ago, I did not quite

20 understand this provision. I now understand it. The way

21 the law currently works, if I give money to somebody and

22 they are a tax-exempt entity, then I get to deduct that

23 contribution.

24 We are bringing in now a concept whereby I can get a

25 benefit from selling the property to them, not giving it

1 to them. I think this has a pernicious effect that has
2 not been well thought through, and I would like to give
3 you an example of it.
4 If I could get you to look at my little chart here.
5 I do not know if you can see it or not. But basically,
6 let us say that you have got a school here and you could
7 have an orphanage, you could have a church, whatever,
8 next to you. Then you have got a piece of property in
9 the middle, and then you have got a conservation reserve
10 on your other side.
11 Let us say that you are going to sell your property
12 and the school wants to expand. It wants to build new
13 buildings which it needs to provide education for the
14 children. It does not want to tear down this school and
15 build somewhere else, but it does not have enough
16 property to build.
17 What this provision says, is that if you sell your
18 land to the school, which is to the local taxpayer, you
19 have got to pay a 20 percent capital gains tax on the
20 capital gain you get, but if you sell it to the
21 conservation group, you only have to pay a 15 percent
22 capital gains tax rate.
23 So what it does, is it advantages conservation
24 relative to schools, orphanages, churches, any other
25 group in America. I think there are two questions here.

1 One, is it is one thing to say if you are giving things
2 to groups that we deem as nonprofit you get a tax
3 advantage from it. I support that.
4 But when you are selling something, to say that it is
5 treated differently for tax purposes based on who you
6 sell it to, this, it seems to me, is moving in a
7 direction that we want to stay away from, where your
8 income you generate is taxed differently on how you
9 generate it, who you sell the property to. I think that
10 is one problem.
11 But a second problem is, do we really want to say
12 that if you sell your property to a school that needs to
13 expand next to you, that you pay a 20 percent capital
14 gains tax rate, but if you sell it to a conservation
15 group you pay a 15 percent tax capital gains rate?
16 Do we want to advantage them relative to schools,
17 orphanages, churches, et cetera? I do not think we do.
18 I think we really do not want to move into this area of
19 taxing differently based on how you generate your income
20 through a property sale.
21 But if we are going to do it, you know that we are
22 going to end up having to do it for every group. We
23 cannot discriminate against taxpayers through schools
24 relative to conservation, or orphanages, or the VFW, or
25 whoever is next door.

1 So I think we would be well advised to strike this
2 provision, and I urge my colleagues to vote for it.
3 Senator Bingaman. Mr. Chairman?
4 The Chairman. Senator Bingaman?
5 Senator Bingaman. I would just like to ask, I have
6 a vague recollection that the President campaigned on
7 this, but he asked for 50 percent instead of 25 percent.
8 I would ask the Treasury, or anybody here at the desk
9 who knows, what the position of the administration is on
10 this proposal, and how do you respond to the Senator from
11 Texas? He seems to make some good points.
12 Ms. Olsen. The President did include such a
13 provision in his budget proposals for last year, and
14 again for this year. It is a 50 percent exclusion rather
15 than a 25 percent exclusion. The purpose is to help
16 conservation organizations acquire important land for
17 conservation purposes, and the administration does
18 support the principles behind this proposal.
19 We would put some provisions in that would slightly
20 limit its applicability to ensure that it is land that is
21 acquired directly for conservation purposes, but we do
22 support the provision in principle.
23 Senator Bingaman. So you think the concerns that
24 have been expressed by the Senator from Texas are not
25 valid? [Laughter].

1 Senator Gramm. Do not embarrass the lady.
2 Ms. Olsen. I would never say that the Senator's
3 concerns were not valid.
4 Senator Bingaman. That is all I have, Mr. Chairman.
5 The Chairman. Further comments? Senator Grassley?
6 Senator Grassley. I think a key point was made by
7 Mrs. Olsen about, the President had this in his budget
8 for two years. There are 11 of my fellow Finance
9 Committee members that have co-sponsored a bill, 1329,
10 that is already in on this issue.
11 So, I hope those of you who have done that know who
12 you are, because that will take care of Senator Gramm.
13 [Laughter]. But beyond that, I think you ought to look
14 at farming as an example. Land may be the only asset
15 that a family has. They may want to protect the land for
16 conservation purposes.
17 This provides a necessary incentive under current tax
18 law. The land sales, even for the conservation-related
19 use, would trigger a huge capital gains tax and severely
20 diminish the family' retirement income.
21 If a tax reduction on the sale of land for
22 conservation easements were available, then the farm
23 family could realize the financial value of his land, and
24 at the same time, help assure protection for
25 environmental and other natural reasons.

1 Also, it is not a charitable deduction and an
2 exclusion of gain. It would only be an exclusion if the
3 land is sold, not both on the same piece of property.
4 So, I ask my colleagues to vote against Senator Gramm.
5 Senator Nickles. Mr. Chairman?
6 The Chairman. Senator Nickles.
7 Senator Nickles. I appreciate the arguments Senator
8 Gramm is making, and also that Senator Grassley is
9 making. It seems to me like the solution would be that
10 if you want to encourage land donations from farms, or
11 ranches, or others for conservation purposes, Senator
12 Gramm makes a good point.
13 Maybe we should encourage gifts and donations to
14 churches and schools and other charities. Maybe we
15 should say we would have a capital gains rate, as
16 proposed under this amendment, of 15 percent for
17 charitable contributions, period, and just reduce capital
18 gains.
19 Senator Bingaman. Mr. Chairman, I am confused at
20 this point. I thought that if you owned this land, you
21 have got a choice. You can give it away and take a full
22 deduction on whatever the value of it is, and that is
23 regardless of who you give it to, or--
24 Senator Gramm. If they are a tax-exempt
25 organization.

1 Senator Bingaman. Right. If they are a tax-exempt
2 organization. Right. Whether it is the church, or
3 whether it is an environmental organization, or whoever
4 it is. If you do not want to give it away, if you want
5 to sell it, you can sell it.
6 There is an advantage of selling it to the group that
7 is going to put it in the conservation easement. That is
8 what this provision that Senator Gramm is objecting to
9 does. This provision would give them a 25 percent
10 reduction in the capital gains they have to pay on what
11 they obtain from that sale. The President asked that we
12 give them a 50 percent deduction on the capital gains
13 that they realize. Is that accurate?
14 The Chairman. Yes, it is.
15 Senator Gramm. Mr. Chairman?
16 The Chairman. Senator Gramm?
17 Senator Gramm. Mr. Chairman, let me, first, make it
18 clear that I am not striking all of the provisions of the
19 President's proposal and I am not striking everything
20 that is in the bill that some people have co-sponsored.
21 I am raising the following point, which I think is a very
22 serious point, and I want to urge my colleagues to please
23 look at it.
24 First of all, if you want to give something away,
25 then if you give it to somebody who is engaged in a

1 purpose that we deem should be tax-exempt, you get the
2 tax deduction. This is bringing in a concept that says
3 you can sell it for profit, but yet you can get a tax
4 advantage based on who you sell it to.
5 Now, I submit, number one, that is a dangerous
6 concept. But the second point is, why in the world would
7 we want to have a tax provision that says, if you have
8 got a school next to you, you have got a piece of land,
9 then you have got a conservation reserve next to you and
10 you decide to sell the land and the school wants to buy
11 your land to expand the school, if they cannot buy your
12 land they cannot expand, they have got to build a new
13 school, tear down the old one, whatever they have got to
14 do.
15 Why should we say, if you sell your land to the
16 school you have got to pay a 20 percent capital gains tax
17 rate, but if you sell it to the conservation group you
18 have got to pay 15 percent? Are we saying that
19 conservation is a higher order than education, or if it
20 is an orphanage, or if it is a church, or if it is the
21 VFW?
22 I just want to urge my colleagues to not set up a
23 situation--it is one thing to encourage giving. It is
24 another thing to try to distort the marketplace where
25 people are selling.

1 I would say that if people own a farm in Iowa or
2 Texas and they want to give it for conservation, God
3 bless them. But if they want to sell it, it seems to me
4 that we ought not to differentiate whether they sell it
5 to a church, whether they sell it to a school system, or
6 whether they sell it for a city park. I just think it is
7 very bad tax policy, and I hope we will strike it.
8 Senator Graham. Mr. Chairman?
9 The Chairman. Yes, Senator Graham?
10 Senator Graham. Mr. Chairman, I would like to ask a
11 question and then make a comment.
12 The Chairman. Sure.
13 Senator Graham. The way this is described, it says,
14 "strike the incentive for donating conservation
15 easements, strike the capital gains--"
16 Senator Gramm. No, no. I did not offer that
17 amendment.
18 Senator Graham. Oh, you did not?
19 Senator Gramm. The amendment I offered was a simple
20 strike of the 25 percent exclusion made for qualifying
21 conservation purposes, just the middle, and a strike
22 motion is always in order.
23 Senator Graham. The exclusion is, the prepositional
24 phrase, is "for conservation easements." So my question
25 is, are we talking here exclusively about easements as

1 opposed to fee-simple title to property?

2 Ms. Olsen. Senator Graham, the proposal would have

3 to meet the definition under Section 170(h) which is for

4 conservation easements, but it would be the ability to

5 sell real estate that met any of the purposes, which are

6 protection of an ecosystem, wetlands, things to that

7 effect. It is not limited just to a conservation

8 easement. It is the exclusion of capital gain for the

9 sale of land.

10 Senator Graham. So this misrepresents what the

11 amendment is. To me, if the only thing we are talking

12 about is an easement, a school does not very often buy--

13 Senator Gramm. This is just the sale of the

14 property, as I understand it.

15 Senator Graham. But an easement is one of the

16 bundles of interest in property. You can sell easements

17 distinct from selling the fee-simple title. It would be

18 a rare thing for a school to buy an easement because they

19 want to have the fee-simple title to build the school on,

20 I assume.

21 Whereas, it is very common in conservation to sell

22 easements which essentially restrict the use of the

23 property to whatever its previous state was, wilderness,

24 agricultural, or a non-developable state.

25 If this is an appropriate statement of what the

1 provision is, I think it is--

2 The Chairman. Senator, I think the description

3 there is inaccurate. Mr. Sullivan, could you describe

4 this provision?

5 Mr. Sullivan. You are correct, Senator Graham. The

6 person sells the property to the buyer.

7 Senator Graham. No. But is it the whole interest

8 or just an easement? That is the question.

9 Ms. Paris. Senator, it has to meet one of the

10 qualified real property interests, which is the entire

11 interest that the owner has, the remainder interest or

12 restriction, in perpetuity, which is a conservation

13 easement.

14 Senator Graham. So this can apply to the total

15 title to the land, not just to an easement.

16 Mr. Sullivan. Correct.

17 Ms. Paris. Unless it is a qualified mineral

18 interest.

19 Senator Thomas. You would not have a capital gain

20 on an easement.

21 Senator Graham. Oh, you might.

22 Senator Thomas. I do not see how.

23 Senator Graham. As a value.

24 Ms. Olsen. You do. You can.

25 Senator Nickles. Mr. Chairman?

1 The Chairman. Senator Nickles?

2 Senator Nickles. Just another suggestion. I do
3 think there are some inequities here that Senator Graham
4 has pointed out. Maybe the solution would be if a person
5 or entity sells property to a charitable organization,
6 any charitable organization, they would be entitled to a
7 15 percent capital gain rate.

8 So we are not choosing between, one, conservation,
9 versus a church, versus others. We just have a lower
10 rate if they sell the property to a qualified charitable
11 organization. Yes, that costs a little bit more. But
12 maybe not, because some of us think we ought to reduce
13 capital gains, period.

14 Senator Gramm. Mr. Chairman?

15 The Chairman. One more. It is about time to wrap
16 up this discussion.

17 Senator Thomas. Just a comment.

18 The Chairman. Senator Thomas.

19 Senator Thomas. It depends. If you are looking for
20 conservation and open space, and so on, it is the
21 difference between having a conservation easement and
22 having a school built on it. If you want to be open
23 space, then it is one thing. If it is a school or a gym,
24 it is something else. So, I think there is a
25 differential.

1 The Chairman. Yes. I might say, this is, I think,
2 a very important amendment. I understand some of the
3 arguments that have been made here, but it is important
4 to remember that a huge, important value in this country
5 is open space. We have a lot of land that is being
6 developed very, very quickly.
7 Why is that? It is primarily because, at least in
8 many respects, the landowner cannot give, say, a
9 contribution. They cannot donate the land. Why?
10 Because there is no income for which he can take the
11 deduction. It just does not exist.
12 An awful lot of farms and ranches in this country are
13 land rich and cash poor. They do not make any money.
14 They have got no income on which to take the deduction.
15 But we are trying to protect the value of more open space
16 and conservation of this country. So, this amendment
17 does that.
18 It is much less generous than the one proposed by the
19 President for two years, but it is to help those farms
20 and ranches and entities that cannot donate because they
21 have no cash to apply the deduction to, to at least be
22 able to sell, and be incented to sell to a qualified
23 buyer, that is, a charitable organization, and for the
24 purpose of conservation and open space. That is what
25 this is all about. I think this amendment should pass.

1 Senator Gramm. Mr. Chairman, you think the
2 amendment should pass?
3 The Chairman. No. I think the--[Laughter].
4 Senator Gramm. If so, I will stop. Look, let me
5 just say this. I am not going to belabor this. But if
6 this amendment does not pass, I am going to offer on the
7 floor, seriatim, every bleeding heart program you can
8 dream of to get the same exemption. They are going to
9 prevail.
10 So, you cannot jump into this thing with just one
11 little toe. The idea that we are going to tax income
12 based on its source flies in the face of everything we
13 have ever done in American tax policy.
14 The Chairman. I doubt that.
15 Senator Gramm. Well, I think, as a general
16 principle, we are getting into really uncharted waters
17 here. But, in any case, as much as I value open space, I
18 do not value it more than schools, or orphanages, or
19 churches. I am sure, with a little thought, I could come
20 up with something even better.
21 But the point is, you are discriminating in terms of
22 the sale of private property, and I think that you either
23 ought to give it to everybody or nobody. My proposal
24 here is to not give it to anybody. If this amendment
25 fails on the floor, I am going to give you a chance to

1 give it to everybody.

2 The Chairman. Questions on the amendment?

3 Senator Thompson. Mr. Chairman?

4 The Chairman. Senator Thompson?

5 Senator Thompson. Can I ask one question? I notice
6 here that this kicks in if the person acquiring the land
7 provides the taxpayer with a letter stating that their
8 intent is to use the land for a qualified purpose.

9 Has there been any thought as to how that is
10 administered? Obviously somebody could get the tax
11 benefit with a letter of intent in hand and the recipient
12 may or may not go ahead and do what they said that they
13 were going to do.

14 How do you go back and recoup a situation where they
15 do not follow the intent, or somebody sets up a company
16 in order to get the benefit of this and gives letters to
17 various people, and buys land, and then does not fulfill?
18 Administratively, has there been any thought to this?

19 Ms. Paris. Senator Thompson, it is under the same
20 rules and format of Section 170(h), which is where the
21 conservation easement rules are.

22 Only a qualified charity whose charitable purpose is
23 the preservation of land for conservation purposes is an
24 eligible purchaser, or a federal, State, or local
25 government that is going to be purchasing the property

1 for one of the three areas that are allowed.

2 That is the preservation of open space, the

3 protection of a natural habitat such as a wetland, or for

4 public recreation. So, you have to be in that class

5 prior to. The letter of intent was with the expectation

6 it would restrict any future transfers to any other

7 charitable organizations or intergovernmental properties.

8 We are working on the assumption, my understanding is

9 in reading the President's proposal and then also what

10 has been done on S. 1329, is that the dollars that are

11 being used to buy the land, they are expecting to perhaps

12 participate in the reduction because of the savings in

13 the capital gain tax for the charity.

14 Mr. Sullivan. It might risk its tax-exempt status.

15 Senator Thompson. I was just wondering if they have

16 to fulfill the purpose within a length of any period of

17 time, or if they could be their present intent but they

18 could change mind later.

19 Ms. Paris. It is in perpetuity. The restriction

20 has to be in perpetuity.

21 Senator Thompson. I am not talking about that. I

22 am talking about, in order to get the benefit of this,

23 they have to provide the seller with a letter of intent

24 for certain things. All I am saying is, what if they do

25 not fulfill what their intention was at that time?

1 Mr. Sullivan. The IRS could proceed against the
2 tax-exempt organization as long as it is in existence.
3 Senator Thompson. Ten years later? I am just
4 wondering how difficult it is going to be to administer
5 this and what kind of Pandora's box, perhaps, we are
6 opening up.
7 Senator Nickles. Mr. Chairman?
8 The Chairman. One more, then we are going to vote.
9 Senator Nickles. Mr. Chairman--
10 Senator Kyl. Mr. Chairman, I have not spoken to
11 this and I really want the opportunity to do so, please.
12 The Chairman. Then you are the one more.
13 Senator Kyl. No, Senator Nickles was next.
14 The Chairman. No, no. You are next. Senator Kyl.
15 Then we are closing off debate.
16 Senator Nickles. Mr. Chairman, I want to make--
17 The Chairman. No. Senator Kyl has the floor.
18 Senator Kyl. Well, let me yield briefly to Senator
19 Nickles.
20 The Chairman. All right.
21 Senator Nickles. I think the solution is to reduce
22 the capital gains rate to 15 percent, period, not just on
23 the sales of charities. But you are asking people to
24 jump through a lot of hoops to be a qualified
25 conservation contributor, based on the intention of the

1 purchaser, maintaining that status for 5 points or for a
2 25 percent reduction in capital gains. I really think
3 the real solution is to reduce the capital gains rate to
4 15 percent for anybody.
5 The Chairman. Senator Kyl?
6 Senator Kyl. Thank you, Mr. Chairman.
7 There is a group in Arizona that is trying to take
8 advantage of this, and I support it. The concern I have
9 is that if it is also providing a preference for sales to
10 government--and that is what Ms. Paris just said the
11 effect of it was--then I do have a concern about it.
12 In a State like Arizona where only 12 to 13 percent
13 of the land is privately owned, just stop and think about
14 that for a just a moment. Government owns about 87 to 88
15 percent of the land in Arizona.
16 Most of it is the Federal Government, much of it is
17 Indian tribes. The tax base, therefore, is shrinking
18 every time there is more land that goes into government
19 hands.
20 The trend is, Indian tribes are buying land in
21 quantities like 500,000 acres. Because of land trades,
22 the more valuable land is going into the private hands in
23 exchange for large quantities of less valuable land,
24 which is going into federal hands.
25 The net result is, I have taken a very strong

1 position of no net loss of private lands in Arizona.
2 With respect to any of the legislation that we promote
3 conservation by or other good purposes, if that land is
4 going to go into government hands then I cannot support
5 this.
6 Yet, I support the concept, especially for this Malpi
7 group in southern Arizona. I suggest that there are some
8 changes that might be made to this to make it more
9 palatable to all of us, because I support it, but I
10 cannot support it if it is going to permit sales to the
11 government.
12 Now, let me just ask this question. Would the
13 sponsors of the proposal that is in the bill be willing
14 to provide for the charitable trust to receive the land
15 and the benefit go for sale to that entity, but not a
16 sale to government? Government does not need more land,
17 especially in a State like Arizona.
18 Senator Bingaman, I think, is very supportive,
19 generally, of this concept, are you not?
20 Senator Bingaman. I certainly did not mean to imply
21 that.
22 Senator Kyl. All right. Well, I am sorry. Who is
23 promoting this, primarily, and would they be willing to
24 consider my suggestion?
25 The Chairman. Well, the answer to the question is,

1 we are certainly willing to look at that. I mean, I do
2 not know of all of the ramifications of what you have to
3 say, and some would question whether an Indian tribe is
4 the government.
5 Senator Kyl. It is a sovereign entity. It is
6 certainly a government, there is no question about that.
7 The Chairman. Well, but it is not the Federal
8 Government.
9 Senator Kyl. Well, the government holds the Indian
10 land in trust. The government actually owns the Indian
11 land.
12 The Chairman. But the main point is, yes, we are
13 willing to consider it, but I would have to see the
14 language.
15 Senator Kyl. Well, the language is very simple.
16 The 15 percent capital gain is for a sale to a charitable
17 trust organization, not to a governmental entity.
18 The Chairman. I cannot accept that at this point,
19 not knowing the ramifications. I would have to think it
20 through. I think it is not proper to, on the fly, adopt
21 an amendment or commit to a proposition that is so
22 sweeping as that.
23 The question is on the Gramm amendment. All those in
24 favor say aye.
25 [A chorus of ayes]

1 The Chairman. Those opposed, no.

2 [A chorus of nays]

3 The Chairman. The amendment does not pass.

4 Senator Kyl. Mr. Chairman?

5 The Chairman. Senator Kyl?

6 Senator Kyl. Thank you.

7 I had the cousin to the Breaux amendment. It is an
8 amendment that would enhance charitable giving to
9 foundations or entities that provide scholarships to
10 students attending school, or to the schools directly. It
11 is my amendment number three.

12 It is more modest than the approaches that several
13 States have taken, but Arizona, Florida, and Pennsylvania
14 all have tax breaks, individual and/or corporate tax
15 breaks for these contributions to scholarship funds.

16 In Arizona, about 19,000 students have had the
17 benefit of this as a result of about $32 million being
18 donated to 30 scholarship-granting organizations in our
19 State.

20 Pennsylvania, about 75 nonprofit organizations
21 operate there, and in Florida, they expect to distribute
22 about 14,000 scholarships by the year's end.

23 My proposal here is a little bit more modest, in that
24 we only provide a $250, or $500 for couples filing
25 jointly, credit and $50,000 for corporations. In order

1 to claim it, you would have to either donate directly to
2 a school or to an organization that gives the
3 scholarships to elementary and secondary students.
4 So this, again, is another way to really promote
5 giving one of the most important things to all of us,
6 which is the education of our children. Most of these
7 scholarships, obviously, go to kids of limited means.
8 Senator Grassley. Mr. Chairman?
9 The Chairman. Senator Grassley?
10 Senator Grassley. I understand that the State of
11 Arizona has championed these sorts of tax credits for
12 scholarships, so obviously I know of the Senator's
13 interest in it and his interest in education, generally,
14 and in very sincerely promoting this.
15 Also, Senator Baucus has had a longstanding interest
16 in education tax credits as well. Because of that, and
17 also because of September the 11th, or prior to that, we
18 talked in very general terms about working on another
19 education tax bill. We also hoped to get back to this
20 very soon.
21 I was just wondering if the Senator would be able to
22 hold back his amendment, get a promise for hearings on
23 the subject or some other forum in which the merits of
24 the proposal can be debated and worked on.
25 Senator Kyl. Mr. Chairman, if I can respond to

1 Senator Grassley. The House Ways and Means Committee, as
2 I understand it, is going to be marking up legislation to
3 establish a similar credit.
4 Now, mine is pretty modest at $250. But the Senate
5 is very likely, therefore, going to have a House-passed
6 bill on this subject this year. If, Senator Grassley,
7 you and Senator Baucus feel that we could have some
8 hearings soon in time to be able to consider what the
9 House does, and perhaps put out something separately
10 ourselves that might be an alternative to the House-
11 passed bill, I would not have any objection to that. But
12 I have been working on this now for over a year.
13 And Senator Baucus, I apologize. I have not
14 specifically asked you for a hearing, but my staff has
15 approached your staff and not gotten any indication that
16 there would be willingness to have a hearing in any
17 timeframe that would fit into this schedule.
18 So, I am a little reluctant to do that. But
19 obviously, if you make that commitment and Senator
20 Grassley and you want to do that, that is an alternative
21 to us doing it right here at this time. But we really do
22 need to consider this.
23 The Chairman. Well, Senator, I will make every
24 effort to try to have a hearing on the basic question.
25 Our schedule is getting a bit full, so I can not make it

1 a guarantee. But I do make a good faith commitment, and
2 a strong good faith commitment, to try to have a hearing
3 on this subject. I think we could probably squeeze in a
4 hearing someplace. That should not be too difficult.
5 Senator Kyl. Yes. I think that is Senator Grassley
6 is saying. Your good faith commitment is good enough for
7 me. I would just suggest this. There is going to be a
8 little time before this bill goes to the floor, so we
9 have time to work on getting a hearing scheduled, not
10 within that timeframe, necessarily, but at least getting
11 it scheduled.
12 The Chairman. Right.
13 Senator Kyl. So what I would suggest, is if we can
14 do that, then I would withhold on this. But I would
15 certainly reserve the right to bring this to the floor if
16 we have not been able to make progress on that.
17 The Chairman. Certainly.
18 Senator Thompson. Mr. Chairman?
19 The Chairman. Senator Thompson?
20 Senator Thompson. Just a comment. I appreciate
21 very much what my friend is doing here. I must say,
22 though, that we are now using the Tax Code to distinguish
23 between charities. Maybe we are already doing that, I do
24 not know. But it looks to me like we are really going
25 down somewhat of a new road here, and I just have to

1 express my concern about that.

2 Senator Graham. Mr. Chairman?

3 The Chairman. Senator Graham?

4 Senator Graham. Mr. Chairman, I had filed several

5 amendments. I just want to talk briefly about two of

6 them, and I believe you have indicated an interest or a

7 willingness to enter into colloquy on one of those.

8 The first, is the issue of the corporate tax

9 shelters. As I understand it, the essential result of

10 adopting the provisions that are going to be before us

11 today will be greater transparency, and that is a good

12 thing that stockholders, the general public, and the IRS

13 will be aware of these tax shelters.

14 But I do not think it goes far enough. I believe we

15 need to set a standard as to what is acceptable in terms

16 of being able to get the benefit of significant tax

17 treatment, and that that standard should be what is

18 generally referred to as economic substance, that the tax

19 shelter would have to indicate that there is some

20 economic reality, some benefit in the marketplace to what

21 they are doing, not just avoiding taxes as the reason for

22 setting up this particular structure.

23 We have had a bath of examples in the last several

24 months of where, off books, partnerships were created and

25 other inventive devices which were done solely to reduce

1 taxes and, frankly, to be able to hide from the
2 stockholders the reality of what was going on in the
3 corporation, with no economic benefit in terms of what
4 the capitalist market-based economy is supposed to be
5 committed to accomplishing.
6 So, I have an amendment, and I noticed that Senator
7 Kerry has a very similar amendment, to insert the
8 economic substance standard as a codified standard in our
9 tax law. Today, it is an evolving concept from a variety
10 of judicial opinions.
11 As was pointed out in the March 21 paper by the Joint
12 Committee on Taxation, this has been a very uneven and
13 irregular process, so that if you live in one circuit of
14 geography you get a different treatment than if you live
15 in another circuit.
16 I think there should be national consistency and
17 reliability of the standard by which these tax shelters
18 will be adjudged.
19 I am not going to offer this amendment in this
20 committee today, but I am putting the committee on alert
21 that it would be my intention to offer this when this
22 bill comes to the floor.
23 It also will help deal with the concern of Senator
24 Bingaman, with which I associate myself, and that is the
25 fact that we are sending to the floor a bill that is

1 substantially under water in terms of its offsets. This
2 would go all the way and beyond, in terms of financing
3 the cost of this legislation, based on the estimates of
4 the CBO as to what the adoption of an economic substance
5 standard would mean.
6 The second area where I am also not going to offer
7 the amendment as filed, is to the point of the beginning
8 of a process of looking at our complex Tax Code. I was
9 impressed several years ago, when we adopted the IRS
10 reform bill, how well the process that preceded
11 congressional action worked.
12 We set up a commission which had a very focused
13 responsibility, to look at the administration of the Tax
14 Code. That commission, which was nonpartisan,
15 professional, made up of people from a variety of
16 perspectives who were knowledgeable about the
17 administration of the Tax Code, made recommendations
18 which were so compelling that we virtually adopted all
19 those that were submitted to us.
20 I think that lesson has applicability to the
21 substance of the Tax Code, that we ought to be looking at
22 a process which, over time, would focus on specific areas
23 of the Code, with experts to do the initial look, then
24 submitting it to Congress for our constitutional
25 responsibility of ultimate action.

1 It seems to me that the international tax provisions
2 of the Code make a very good beginning point for that
3 process, one of the reasons being that it is a high
4 priority now. It has got significant implications to our
5 international competitiveness, and the fact that it is a
6 relatively containable part of the Code. That is, its
7 provisions do not, as do many other areas of the Code,
8 have leak-over effects in other areas of the Code.
9 So my amendment would have established such a
10 commission and a process which was intended to look at
11 the international tax provisions, but really be the
12 harbinger of a longer range commitment, looking at the
13 entire Code for purposes of simplification.
14 It is my understanding that the Chairman has some
15 concern about that approach, but has indicated a
16 willingness to set up a group of a more informal nature
17 to focus on the international tax provisions, and I think
18 that is a good faith suggestion which I am prepared to
19 accept as a means of getting this process under way.
20 I hope that we can do so as expeditiously as
21 possible. I believe this also has the concurrence of
22 Senator Grassley as a means of starting this process.
23 So I would ask, Mr. Chairman, if the colloquy could
24 be inserted in the record of today's hearing.
25 The Chairman. It is so inserted.

1 [The information appears in the appendix.]

2 The Chairman. Before we do that, though, I wan to
3 make it clear that the prior Kyl amendment was withdrawn,
4 just for the sake of the record. I might say, too, I
5 appreciate your comments, Senator, about the economic
6 substance.

7 But I think it is also important for us to remind
8 ourselves, and it kind of reminds me of H.L. Menkin, a
9 *Baltimore Sun* journalist who once said, "For every
10 complicated problem, there is a simple solution and it is
11 usually wrong."

12 Economic substance us certainly one of the major
13 criteria that the IRS looks at, and that we should look
14 at, in determining whether a tax transaction is an
15 abusive, sham transaction. But there are lots of tests
16 that are used, and it is economic substance, it is sham,
17 it is step-up, it is form-over-substance.

18 There are all kinds of different criteria that the
19 IRS uses, and I would just urge us not to think that
20 codification of economic substance is going to really
21 help much in terms of rooting out abusive transactions.
22 I can see some company just arguing, well, what percent
23 is economic substance?

24 We are getting a little bit of economic substance. I
25 appreciate your point, Senator. But it is also important

1 to remind us that if we are really going to get our job
2 done here, we have to be very creative about what we are
3 doing here.

4 But certainly, part of the colloquy that you referred
5 to about a bipartisan, informal working group here at the
6 Finance Committee to regularly look at the international
7 tax schemes and abusive transactions, and even those
8 without economic substance, is a good idea.

9 Senator Grassley?

10 Senator Grassley. Yes. I offer an amendment
11 regarding individual development accounts, co-sponsored
12 by you, Mr. Chairman, and by Senator Hatch.

13 I modify my amendment to allow that it be paid for by
14 imposing and collecting Custom user fees for a sufficient
15 period of time to offset the bipartisan amendment on
16 individual development accounts. It will provide a
17 limited opportunity to give this program a chance to
18 prove itself.

19 The program encourages low-income families and
20 individuals to save for home, small business, or
21 secondary education. These accounts achieve this by
22 providing a dollar-for-dollar match, up to $500 a year
23 for families saving money.

24 The families can have up to $2,500 in savings,
25 matched over a five-year period. The funds for the

1 program are provided in a tax credit to banks or
2 transferrable credit in credit unions. The banks and
3 credit unions receive credits only to the extent that
4 families are participating in the program.
5 Senators should know that the development account
6 proposal is of great importance to the main sponsors of
7 the CARE Act, Senators Santorum and Lieberman. They
8 originally proposed a $12.5 billion program for
9 development accounts.
10 However, I share many of my colleagues' concerns that
11 this is a program that is still in its infancy and is
12 such a significant allocation of resources at this time,
13 it is surely inappropriate.
14 This amendment is responsive to the concerns that I
15 have, and others in the committee, regarding development
16 accounts. So, the amendment provides for only a $450
17 million program, and the program sunsets.
18 In addition, the amendment provides a significant
19 cost benefit test that must be met before additional
20 funds are distributed. Finally, we have required several
21 changes to the program to ensure greater accountability
22 of the funds.
23 The Chairman. Is there discussion on the amendment?
24 Senator Nickles. Mr. Chairman?
25 The Chairman. Senator Nickles?

1 Senator Nickles. I am just trying to better
2 understand this. It is $450 million over what period of
3 time?
4 Senator Grassley. Two years and three months.
5 Mr. Sullivan. Senator, it is a 10-year cost of
6 providing the IDA program as provided in the amendment.
7 Senator Nickles. But it is a two-year program.
8 Mr. Zerbe. No, Senator. Let me explain. What it
9 is, is it is a program that is basically for 300,000
10 accounts that will basically be released over time, over
11 a nine-year period, with increments of 100,000, depending
12 on usage, quite frankly. It could go below 100,000.
13 Then the final 100,000, assuming that certain cost
14 benefit tests are met, is only when the last 100,000
15 would be released. That is down the road several years
16 from now, so it is spread out basically over several
17 years, and then it does sunset after that. Yes, sir.
18 Senator Nickles. I am still trying to get a better
19 idea of how this works. So you have it set up to where
20 300 individuals or couples--is that correct?
21 Mr. Zerbe. Three hundred thousand.
22 Senator Nickles. Three hundred thousand. That is
23 what I meant. Three hundred thousand individuals or
24 couples could benefit.
25 Mr. Zerbe. Yes, sir.

1 Senator Nickles. And they would have a savings up
2 to $500, and the government, the bank, or the financial
3 institution would match that. The bank would be
4 reimbursed by a reduction in their taxes.
5 Mr. Zerbe. Yes, sir.
6 Senator Nickles. I think I heard you say credit
7 unions. Credit unions do not pay taxes. How do we do
8 that?
9 Mr. Zerbe. This would be a transferable credit,
10 like we did in the energy bill.
11 Senator Nickles. They could sell it?
12 Mr. Zerbe. Yes, sir.
13 Senator Nickles. So groups that do not pay taxes
14 are going to get a tax credit to match contributions?
15 Mr. Zerbe. Yes.
16 Senator Nickles. Then the individual, let us say,
17 saves $40 a month, $500 a year. The institution they
18 save it with matches that, so now they have $1,000. They
19 do that for five years and they get a subsidy of $2,500.
20 They put in $2,500. They have made a little interest.
21 Now, can they spend that money as they go?
22 Mr. Zerbe. No, sir. They have to use it for
23 basically three purposes only that they are allowed to
24 use it for. They can use it for a first home, for
25 secondary education, or to start a business.

1 The financial institution basically makes those
2 payments directly to that third party, directly to the
3 lending institution or to the college or university.
4 The Chairman. Any further discussion?
5 Senator Nickles. I am just still trying to figure
6 this out. So can an individual and a spouse both
7 qualify?
8 Mr. Zerbe. No, I believe that it is just for
9 families. If not, we will make that clear. That is
10 supposed to be just for family.
11 Senator Nickles. All right. So a maximum of $500
12 per family, per year.
13 Mr. Zerbe. Per year. Yes, Senator.
14 Mr. Sullivan. Senator, I believe it is tied to
15 filing status, so if you are married filing joint, head
16 of household.
17 Senator Nickles. Now, can children qualify for
18 this?
19 Mr. Zerbe. No, sir. You have to be over 18 and not
20 a student. There are also income limitations of $38,000
21 for married, $30,000 for head of household, $18,000 for
22 single. And basically you are only eligible if, in that
23 previous year, you were below that income level. That
24 would be adjusted for inflation, though. The $500 is not
25 adjusted for inflation.

1 Senator Nickles. And that would be certified by?
2 Mr. Zerbe. By the financial institutions, by their
3 tax returns, Senator.
4 Senator Nickles. So to qualify, they would have to
5 go to the bank and say, here is my last year's tax
6 return.
7 Mr. Zerbe. Yes, Senator.
8 Senator Nickles. And as a couple, they had to have
9 income less than $38,000, individual less than $18,000?
10 Mr. Zerbe. Yes, Senator.
11 Senator Nickles. Mr. Chairman, I am concerned. I
12 heard my colleague say that it is a 10-year sunset, but I
13 also heard him say it is a two-year program.
14 Senator Grassley. Well, the program sunsets, but
15 obviously the money is going to be saved over a period of
16 time if they qualify.
17 Senator Nickles. The maximum benefit anybody can
18 receive, they only match it for 5 years, or they can
19 match it for 10 years?
20 Mr. Zerbe. No, sir. The maximum that they can have
21 is for 5 years, for $2,500, is the ceiling. Yes,
22 Senator.
23 Senator Nickles. I do not know how many millions of
24 people could qualify if it is wide open. Once it is out
25 there, this may be a pilot that may be a brand-new

1 entitlement program that could be costing the taxpayers.
2 I do not know.
3 If there was no cap, if you did not have it capped at
4 300,000, how much could this cost? Because I can see, if
5 it is successful--and it may well be very successful.
6 People like to get something for nothing, or have a $500
7 gift per year. How much could this cost?
8 Mr. Zerbe. Senator, the original proposal was $12.5
9 billion, and I believe that was under a vision of
10 basically full entitlement that all eligibles could
11 participate in. I believe that was a 10-year figure,
12 $12.5 billion. Yes, Senator.
13 Senator Nickles. It is $12.5 billion. And the cost
14 of this pilot is how much?
15 Senator Grassley. It is $450 million.
16 Senator Nickles. It is $450 million. I am going to
17 just register my reservations about it, because I can see
18 that we may be starting something that will be difficult
19 to turn off, and enormously expensive.
20 The Chairman. Senator Kyl?
21 Senator Kyl. Thank you, Mr. Chairman.
22 I would like to ask Mr. Zerbe some questions as well.
23 I have a memo from staff that has several conclusions
24 about the failure of the existing pilot programs, and
25 this is what I expressed in my opening statement.

1 This is a program that we created pilots for to see
2 how well it work, and before we have analyzed how well it
3 is going to work we are going to now open it up to a much
4 larger, more expansive kind of program.
5 Yet, from what I see here, if you want to go to the
6 trouble of evaluating the pilots, they are not working
7 very well. The drop-out rate to completion is greater
8 than 2 to 1, according to this.
9 There are several listed here, the Ramsay Action
10 Programs, the Central Vermont Community Act, Human
11 Solutions, and so on. In each of these, there is a lot
12 of money that has been spent in federal funds. The fist
13 one, $500,000 has been spent, only 403 open cases. In
14 the next one, $146,800 has been spent, opened zero IDA
15 accounts. In the next one, spent almost $171,000, opened
16 zero IDA accounts, and so on.
17 Mr. Zerbe, are you aware, generally, of the results
18 of at least some of these pilot projects, and could you
19 describe for us your view as to how well they are doing,
20 and discuss both withdrawals and opened accounts for us a
21 little bit?
22 Mr. Zerbe. I am very familiar with those findings,
23 Senator, since I am the one that wrote that memo and
24 wrote those findings. [Laughter].
25 Senator Kyl. I knew I was asking the right person.

1 Mr. Zerbe. Senator Grassley, as you know, is very
2 committed to oversight in all areas. I think what we
3 feel, is that the program that the administration has put
4 forward, and with Senators Santorum and Lieberman, we
5 have worked on a bipartisan basis very vigorously to
6 improve this program and scrub it. There have been many
7 modifications and changes.
8 A good example, is exactly the point you are raising,
9 Senator. You are right, those programs raise enormous
10 questions of why we have spent so much taxpayers monies,
11 yet have seen no results.
12 But under the regime we have here, the taxpayers
13 would not have spent a dime under that because they would
14 not spend a dime until the savings had been realized and
15 that the credit had been matched to the savings.
16 The unfortunate situation with the OCS programs in
17 HHS, is they are issuing grants first and then hoping
18 that something good happens. Here, we do not put out a
19 dime until something good happens. So our hope is that,
20 in that situation, we would avoid that.
21 We have also put in other restrictions that we
22 believe are lessons learned from what has gone awry. We
23 have studied it very closely, I guess is what I would
24 say, and we do believe we have made some changes.
25 But I would say to you also, Senator, that we have

1 put it to an extraordinarily tests. And this would be to
2 Senator Nickles as well, his very valid and good points.
3 This program will not continue, even as it is, unless
4 they have a very strict cost benefit analysis.
5 That means that they have to show, compared to a
6 cadre group, a similarly situated group, just not in the
7 abstract, that the folks that participate versus
8 similarly situated people who do not participate have
9 greater tax payments.
10 Senator Kyl. When does that showing have to be
11 made?
12 Mr. Zerbe. That has to be made, Senator, by 2006,
13 with the release of the third 100,000 group. I think the
14 feeling is, we have to give them sufficient time to get
15 the program up and running.
16 Senator Kyl. So how much money would be authorized
17 prior to the finding being sent to us?
18 Mr. Sullivan. There are 200,000 accounts.
19 Senator Kyl. Can you do the math, real quickly?
20 Ms. Paull. It is 200,000 at $2,5000.
21 Senator Kyl. What is the first three-year cost? I
22 guess that is the easy answer, right? Until 2005, you
23 said, right? So the first three-year could would be?
24 Ms. Paull. The first three years, roughly $100
25 million.

1 Senator Kyl. It is $100 million?

2 Ms. Paull. Yes. Cost to the Federal Government.

3 Although it might be a little bit more than that because

4 of the way we do our fiscal year splits here.

5 Mr. Zerbe. And Senator Kyl, just to give you by

6 comparison, the OCS program is ramped up to, I believe,

7 where it is basically getting appropriated around

8 approximately $40 million per year, just as a comparison.

9 So for that period, the other program will be

10 appropriated at $120 million.

11 Senator Kyl. Do we terminate the program that is in

12 existence today and substitute the new program for it, or

13 do we add the new program to what is already existing

14 that is not working?

15 Mr. Zerbe. That is not in our committee's

16 jurisdiction.

17 Senator Kyl. We, the Senate, is what I am saying.

18 I did not mean you. So we are not doing anything about

19 the existing program which is not working very well. We

20 are just adding a new program that we think will work

21 better, and we will know in about three years. Is that

22 correct?

23 Ms. Paull. Yes.

24 The Chairman. All right. The rules require seven

25 Senators present to transact business. We do not have

1 seven Senators. We are looking to try to find another
2 Senator, and that is not terribly promising at this
3 moment.
4 Senator Lincoln. Mr. Chairman?
5 The Chairman. Senator Lincoln?
6 Senator Lincoln. I have an amendment to offer. If
7 we can set aside the amendment, I could introduce mine
8 and maybe we could discuss it while we were waiting on
9 the additional member.
10 The Chairman. Well, it is probably not a bad idea
11 to discuss it, briefly, if Senators wish to remain. But
12 after several minutes, if we cannot get Senators to
13 return, we are going to have to do this on the floor.
14 Senator Grassley. It might be quicker for Mrs.
15 Lincoln if you wait until Senators are standing up off
16 the floor to consider your amendment. You might get it
17 done quicker.
18 Senator Lincoln. Do you think my chances might be
19 better?
20 Senator Grassley. We are pretty comfortable right
21 now.
22 The Chairman. The chances will be no worse, that is
23 for sure.
24 Senator Lincoln. Well, I am still going to take up
25 everybody's time to discuss it. I would be more than

1 happy to do it now, or whenever you would like for me to.
2 But I was just thinking, if you want to set aside the
3 current one--
4 The Chairman. Why do you not just explain it now so
5 we know what it is?
6 Senator Lincoln. Absolutely.
7 The Chairman. All right. Thanks.
8 Senator Lincoln. All right.
9 The Chairman. The current amendment is now
10 withdrawn and we will discuss the other.
11 Senator Lincoln. Mr. Chairman, it is amendment
12 number 34, which is my first amendment. Under the
13 permitted direct holdings of a private foundation in a
14 corporation, they would be increased from 2 percent to 5
15 percent, certainly within the qualifications that the
16 common stock of the corporation and any other class of
17 stock held by that foundation are regularly traded on an
18 established security market, and more than 50 percent of
19 all classes of stock of the corporation, by both vote and
20 market value, are held by persons who are not
21 disqualified persons. A majority of the board of
22 directors of the corporation are individuals who are not
23 disqualified persons with respect to the private
24 foundation.
25 I think my amendment is certainly consistent in what

1 we are trying to achieve in this bill, and that is to
2 improve and increase the ability of individuals to
3 contribute to foundations and charitable organizations in
4 order to do the good works that we all see and want them
5 to do.
6 Senator Grassley mentioned earlier in one of the
7 debates and discussions that we had that in some
8 instances, maybe a family' assets may be all the assets
9 that a family members have. If it is a family-owned
10 farm, or a family-owned corporation or business, this is
11 perhaps the only or best way that they have to give.
12 This increases their ability to do just that.
13 I certainly would hope that we would not require a
14 family to pay a 20 percent capital gains toll charge on
15 their charitable giving. What we try to do here is allow
16 them the ability to increase their charitable giving to
17 foundations through their stocks. As I said, I think it
18 is very consistent with what we are trying to do in this
19 bill.
20 The Chairman. I appreciate that.
21 I might ask Mrs. Olsen from Treasury, do you have a
22 comment on this proposal?
23 Ms. Olsen. We do not support the proposal at this
24 time, but we are willing to give it further
25 consideration.

1 The Chairman. Could you explain why?
2 Ms. Olsen. Certainly. We think that the limitation
3 that was put in the 1969 Act is probably the right
4 provision. Two percent does seem like it is a de minimis
5 amount, but 5 percent seems like it might be a bit high.
6 The effect of the proposal would be to allow a
7 private foundation to hold up to 5 percent of the voting
8 stock, while allowing disqualified persons to own up to
9 49 percent, perhaps even a higher percentage of voting
10 stock, and this does seem inconsistent with the original
11 intent of the provision as enacted in 1969.
12 We have concerns that the proposal could facilitate
13 the use of private foundations to perpetuate control of
14 business enterprises. That concern might be reduced if
15 the proposal were modified, perhaps, to permit it if
16 there was a demonstration that an unrelated party had
17 effective control of the corporation.
18 Senator Lincoln. May I comment, Mr. Chairman?
19 The Chairman. Senator Lincoln?
20 Senator Lincoln. So the administration does not
21 agree with what we are trying to do in encouraging the
22 contributions to those foundations with an increase. You
23 did state that in the 1969 law, a lot of what we are
24 trying to do is to try and update and increase the
25 ability for individuals to give to those charitable

1 organizations and foundations.

2 There are certain requirements, I think, that the
3 corporations be publicly traded, that a majority of its
4 stock be immediately held, and that a majority of the
5 corporation directors not be disqualified persons.
6 These are pretty meaningful and substantive, the
7 limitations that do exist.

8 Publicly traded companies having to have independent
9 auditors and audit committees composed of independent
10 directors are also other safeguards that are provided
11 there, I think, to some of the questions that you may
12 have brought forth. But I do not know what specific
13 changes that you want to see happen in what we are
14 proposing. Is it necessarily a decrease in the amount or
15 is it more regulation?

16 Ms. Olsen. I think we are completely comfortable
17 with the 2 percent, but 5 percent, we are just not sure
18 that that really fits in the de minimis category that was
19 intended by the 1969 Act. It does seem like a
20 significant increase.

21 Senator Lincoln. So you would prefer to see a
22 lesser number or more regulation?

23 Ms. Olsen. I think what we would like to see, is
24 that there is no effective control by disqualified
25 persons. That could take the form of more regulation.

1 Senator Lincoln. So you would rather see more
2 regulation.
3 Ms. Olsen. I think that that could satisfy the
4 concern that we would have about making sure that a
5 disqualified person does not, in effect, have control of
6 a corporation.
7 Senator Lincoln. Well, as I said, there are
8 certain, obviously, requirements of corporations that are
9 publicly traded, and I think that there are an awful lot
10 of limitations here and safeguards that we currently
11 have.
12 But in speaking to what we are trying to achieve in
13 this bill in increasing charitable giving and the ability
14 of those possibly whose only assets may be in stock of
15 family-owned businesses, I feel like that we have got a
16 reputable standing in what we are trying to do.
17 If you do have suggestions on the regulations that
18 seem to meet your liking, or the administration's liking,
19 we would certainly like to hear from you on that.
20 Ms. Olsen. I would be happy to discuss it with you.
21 Senator Lincoln. Thank you.
22 The Chairman. Thank you, Senator.
23 I might also say that we will now turn to the other
24 two bills, S. 2498.
25 Senator Lincoln. Does that mean that mine is

1 withdrawn and we are going to vote on it off the floor,
2 too?
3 The Chairman. It does.
4 Senator Lincoln. All right. Thank you, Mr.
5 Chairman.
6 The Chairman. And S. 2119, the corporate inversion
7 bill, and the modifications to that bill are hereby
8 incorporated.
9 Ms. Paull. Right.
10 The Chairman. Seeing no further business, the
11 committee will now recess until call of the Chair. We
12 hope to vote on the amendments and the bills immediately
13 following a vote at the Senate this afternoon.
14 No vote has yet been scheduled, therefore, no time
15 for our committee to meet has been scheduled. It is my
16 expectation that we will vote immediately after the next
17 scheduled vote in the Senate.
18 The committee is in recess.
19 [Whereupon, at 12:18 p.m. the meeting was recessed.]
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UNITED STATES SENATE
COMMITTEE ON FINANCE

Max Baucus, Chairman

Thursday, June 13, 2002
10:00 a.m.
215 Dirksen Senate Office Building

Agenda for Business Meeting

I. A substitute for H.R. 7, to provide incentives for charitable contributions;

II. S. 2498, the Tax Shelter Transparency Act; and

III. S. 2119, the Reversing the Expatriation of Profits Offshore Act.

Chairman Max Baucus
Opening Statement
Regarding the Chairman's Mark on
Tax Incentives to Encourage Charitable Giving
June 13, 2002

The Committee will come to order.

We are meeting today to consider how we can help our charities to help our communities.

At a time when all Americans have come together to support the war against terrorism, this is more important than ever.

President Bush said it well. "In order to fight evil, we must do good. [And] it is the gathering momentum of millions of acts of kindness and compassion which define the true face of America."

We all remember what happened after September 11th. Charities delivered food, water, clothing, and counseling.

And, every day thereafter, charities worked to provide even broader assistance to those affected by the tragedies in New York, Northern Virginia and Pennsylvania.

The same kind of work goes on every day, all across the country. In response not only to attacks and natural disasters, but also to the quiet tragedies.

Let me give you a few examples from my state of Montana.

- In 1999, Montana charities received $360 million in contributions

-

- The Montana Food Bank (in Missoula) served 185,000 households in 2000. They served 1,500,000 meals in 2000. The Food Bank received over 600,000 pounds of donations.

- The United Way of Missoula County recently surpassed their fundraising goal for 2001-2002 of $1,150,000. They use these funds for a variety of services: provide health services, youth services, family services, housing services, and senior services.

- Total giving to the University of Montana Foundation totaled $20,919,397. This surpassed the 5 year average of $14,751,285.

- Groups like the Blackfoot Challenge provide local, voluntary solutions to important environmental problems, like restoring stream habitat.

The list goes on.

Folks working in shelters. Churches. Libraries. Scout troops. Schools. Boys and girls clubs. Substance abuse centers. Jails.

All across our communities. All across our country.

This bill is designed to help these folks, by creating a few more incentives, to encourage more contributions to charity.

Let me briefly describe the main provisions of the bill.

The provision that has received the most attention is the above the line deduction for charitable contributions for people who don't itemize their deductions.

Let's be honest here. I have concerns about this provision. We've tried this approach before, and it didn't work well. That's why we eliminated the deduction in 1986.

More specifically, I am concerned that the deduction won't provide much incentive for charitable giving and will make the tax code more complicated.

Nonetheless, President Bush has made this particular proposal his top priority. In light of that, we should give the proposal a chance.

At the same time, we limit the proposal to two years, so that we can carefully study how well it is working.

While the non-itemizer deduction has received most of the attention, there are several other provisions in this bill that have strong bipartisan support and will provide a significant boost to charitable giving.

We provide enhanced deductions for contributions of food, books, computers, and bonds.

As a result, for example, we make it easier for a farmer to receive a fair deduction for giving food to a local food bank. And for a publisher to donate extra books to a local library.

We expand the IRA rollover exceptions to allow individuals to donate their IRAs to charity without taking a tax hit.

We provide several important new incentives for voluntary conservation, such as by contributions of conservation easements, which are so important in Montana and throughout the country.

These are highlights. There are several other important provisions.

All told, this package includes many proposals sponsored by members of the Committee and previously supported by the Senate.

We also have consulted closely with the Administration and with the lead sponsors of the main Senate bill, Senators Lieberman and Santorum.

That covers the charitable provisions of the bill. Let me turn to the other provisions.

To cover the cost of our mark, we have included two proposals Senator Grassley and I introduced earlier this year.

The first proposal goes after the proliferation of abusive tax shelters.

I introduced the *Tax Shelter Transparency Act* with Senator Grassley to encourage more timely and accurate disclosure of these abusive transactions. Under the proposal, promoters, advisors and taxpayers would be subject to stiff penalties for failing to acknowledge these transactions to the IRS.

The mark also includes our legislation to address the growing practice of corporate inversions.

Many American companies have engaged in – or are thinking about – relocating their corporate headquarters in tax haven countries as a tax dodge.

The *Reversing the Expatriation of Profits Offshore Act* – or REPO Act – eliminates the loophole in the tax code that lets a corporation, with nothing more than a file folder or post office box in a tax haven country, escape millions in U.S. taxes.

It isn't right when the majority of taxpayers – the hardware store owners in Butte – pay their fair share of taxes while these big corporations twist their way out of paying their own fair share. This is simply wrong.

But it <u>is</u> the right thing to do to use these proposals to pay for tax incentives to benefit the charitable community. It's the right thing to do – and the right time to do it.

We also include some additional provisions, so that the overall package is revenue-neutral.

I'd like to conclude by thanking my good friend, Senator Grassley, for his help in putting this compromise, bipartisan legislation together. I look forward to working with him, and members on the Committee, to see it enacted into law.

ROBERT G. TORRICELLI
NEW JERSEY

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Statement of Senator Robert G. Torricelli for Senate Finance Committee Mark-up
June 13, 2002

MR. TORRICELLI: I thank the Chairman and Ranking Member for putting together this bill. I know that several members of this Committee have concerns about the policy and the potential implications of this bill, and I understand their concerns. However, I believe Chairman and Ranking Member have put together a balanced proposal that incorporates many of the President's priorities. At the same time the Committee has ensured fiscal responsibility in this matter by including offsets by closing only the most abusive corporate tax inversions.

In my state of New Jersey, I know that this legislation will do much good. In the wake of September 11th, I saw many of my own constituents give to the relief organizations aimed at helping the victims of the World Trade Center and the Pentagon. Many gave more than they could.

Indeed, in one of our greatest tragedies we saw ordinary Americans espouse the noblest virtue of charity. Our bill today builds upon the inherent generosity of Americans and merely affords the same tax treatment to those taxpayers who are not wealthy enough to itemize their deductions.

This bill also incorporates important changes in our IRA laws. By allowing more penalty free rollovers to charity, IRA holders can free up some of their money for the first time and donate to charities that can put it to good use now, rather than years from now. It also contains deductions for donations of conservation easements, which will support open-space conservation in New Jersey and around the country.

I know that there are many other worthy proposals in this mark such as the Social Services Block Grant that I look forward to addressing. Some members have some hesitation in this matter, but it is my hope that we can resolve these differences and move this bill out of Committee.

I thank the Chair.

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ROBERT G. TORRICELLI
NEW JERSEY

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Questions of Senator Robert G. Torricelli for the Record for Joint Committee on Taxation Staff

Finance Committee Markup

June 13th, 2002

In the Joint Committee description of the REPO bill one of the tests of determining whether an inversion has taken place requires that the foreign-incorporated entity "does not have substantial business activities in the entity's country of incorporation, compared to the total business of the group"

This sentence appears to create a very broad definition of substantial business activity. I thought that the intent of this legislation is to stop "file folder" inversions. This sentence seems to take the legislation somewhere else.

Is it possible for a company, especially one in the financial services industry, to have 50,000 employees worldwide and only 20 or 30 in a particular country which may be sufficient to conduct a substantial business?

Under this language, would it be possible for Treasury to conclude that on a comparative basis that business activity does not constitute substantial business activity?

It would be better to drop the words "compared to the total business activities of the group". We would still be able to stop "file folder inversions". If we wanted a more detailed definition of substantial business activity we should use Treasury's more traditional definition of permanent establishment, which is used by in negotiating tax treaties with other countries.

2. Section 845 Related Party Reinsurance Agreements

The Joint Committee description is rather vague in explaining the relationship between Section 845 and Section 482. I would like to clarify this provision to make sure we are not replacing or expanding the internationally recognized, long established, arms length pricing rules applied to related party insurance or reinsurance transactions.

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The Treasury should not be allowed to adjust the amount of taxable income or deduction of the ceding insurance company if the ceding commission premium and other terms of the reinsurance arrangements reflect independent market pricing between or among unrelated persons as normally determined under section 482 of the Code.

Changing these Section 482 principles would create havoc with our trading partners and could be the first step in a trade war over insurance and reinsurance.

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Chairman Baucus, Ranking Member Grassley, thank you for holding this mark up. Upon assuming office, President Bush made clear that this issue would be one of his top domestic priorities. Accordingly, last July, the House passed the Community Solutions Act of 2001 by a strong bipartisan vote. I am pleased that this Committee will now have a part to play in the crafting, and hopefully, in the eventual passage of this important legislation. Our task today is one that I think every Member agrees with, at least in principle, and that is: encouraging charitable giving. Of course, the question then becomes: what is the most effective way to do this? My view is that we do our best work when we remove the federal government as an impediment to citizens' activity, rather than overtly promoting this or that "preferred" activity. Today's mark takes as its base bill the Charity, Aid, Recovery, and Empowerment Act of 2002, S. 1924, introduced by Senator Lieberman in February of this year. S. 1924 was a step in the right direction and I am very pleased that the Chairman and the Ranking Member have been able to improve upon that good work. That said, there are still a number of issues that need to be fleshed out, and I look forward to doing so today.

The bipartisan mark now before us is designed to promote charitable donations by providing a series of tax incentives, and by removing obstacles in the tax code that discourage charitable giving. I have looked at all of the provisions with this goal in mind. While some are consistent with this design, others, I would argue, are not, and thus should not be included in the

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final bill. Let me briefly make note of a few provisions.

The first provision is the so-called charitable deduction for non-itemizers. This provision would allow taxpayers who take the standard deduction to take an additional tax deduction for cash contributions to charity. The deduction would be available only for contributions that in the aggregate exceed $250 ($500 in the case of a joint return), but that are not greater than $500 ($1,000 for joint returns). Not only am I troubled by the cost of this provision, $2.5 billion over 10 years (although it is only effective for two years), I am also troubled by its cumbersome mechanism of enforcement, the potential for taxpayer abuse *despite* the cumbersome enforcement mechanism, and the lack of evidence supporting the claim that it would substantially increase the amount of charitable giving by non-itemizers. I understand that the rationale for the standard deduction was to recognize what people already contributed. I question whether an additional deduction would necessarily promote *more* giving.

The Individual Retirement Account (IRA) charitable rollover provision, I would argue, is a better use of the tax code -- though it, too, is not without its drawbacks. The provision would exclude from gross income otherwise taxable IRA withdrawals from a traditional IRA or a Roth IRA for qualified charitable distributions. Under the provision, taxpayers that are age 70½ and older would be allowed to roll over amounts from their IRA accounts directly to a qualified charitable organization on a tax-free basis. Let me say, I would be much more willing to offer my wholehearted endorsement of this provision if the language could be more narrowly tailored so that faith-based organizations were the primary beneficiaries of this provision, projected to

cost nearly $3 billion over the next 10 years. I believe that faith-based organizations are best-suited to perform charitable acts in the community. Historically, many unfair barriers have been erected to prevent them from maximizing their potential for charitable work. There is a broad and increasing consensus among Americans that these barriers should come down. Targeting this provision's benefits towards faith-based organizations would not only provide a much needed boost to their charitable works, but it would also help to tear down those barriers more quickly.

There is a provision on Individual Development Accounts (IDAs) that was wisely not included in the mark but will be offered during debate. I will strongly oppose any IDA amendments. These accounts are essentially government funded savings accounts for the intended purpose of helping individuals perform an activity – saving money -- that they should be doing on their own initiative. There are 14 IDA pilot programs in operation, but the documented results supporting these programs are notoriously absent. As you know, the Finance Committee has been working closely with the General Accounting Office to produce an evaluation of these pilot programs. It is imperative that we have some concrete data at our disposal before we endorse such a controversial provision. I will wait in strong opposition until there is better information about the results of these questionable pilot programs.

I am also concerned about potential fraud under this provision. We have as an example our experience a similar program -- the earned income tax-credit. It has fraud rates between 20 and 30 percent, according to recent IRS studies. What is to prevent a similar fraud rate under the

proposed IDA program? The IRS is poorly equipped to administer what is essentially an appropriation of money to individuals. Their expertise is in the collection of money. Furthermore, I do not believe that any IDA amendment is relevant to the legislation before us which is designed to increase charitable giving incentives for American taxpayers.

I have only spoken on a few of the tax-related provisions we are considering, but there are a number of others that are a part of this mark. In fact, there are a total of 28 charitable provisions in this bill. Eighteen of these provisions have a negligible (less than $500,000) or moderate (less than $55 million) cost and appear to simplify many of the tax laws concerning charitable giving. Of the remaining ten, I have spoken about two of them – the so-called charitable deduction for non-itemizers and the IRA charitable rollover provision. It is my hope that, as we evaluate the merits of the remaining six proposals (as well as any amendments that are offered today), we keep in mind the shared goal that I spelled out earlier. And that is: to promote increased charitable donations by providing a series of tax incentives and by removing from the tax code features that discourage charitable giving. In trying to determine whether particular provisions warrant our support, we must be mindful, above all else, of the estimated costs of these provisions relative to their expected benefits -- that is, whether they will actually increase charitable giving and do so in a manner that will not encourage fraud or noncompliance.

I would like to take a moment to discuss the offsets that are in the bill -- they are subsumed under the title, "Revenue Raising Provisions." As a general rule, I do not think that so-called offsets are necessary, especially if the tax policy we've enacted is indeed good tax

policy. In other words, the stimulative value of a bill's tax provisions, especially if they're broad based and designed to encourage investment, should, by their very nature, produce their own economic offsets. However, in the case now before us, offsets may be warranted for two reasons. First, as a precaution given our current budget situation, and more importantly, due to the fact that stimulating charitable giving by our citizens does not necessarily stimulate the economy at large.

The Chairman's mark contains revenue-raising provisions to address problems associated with what are commonly known as "corporate tax shelters." The mark generally follows the provisions of S. 2498, the Tax Shelter Transparency Act. These provisions are designed to provide certainty to taxpayers and tax advisors about their responsibilities with respect to reporting, disclosure, and list maintenance. The overall intent -- which I support -- is simple: to encourage more disclosure by taxpayers, especially corporations. By providing certain "safe harbor" provisions for those who disclose the required information, and by imposing more stringent penalties on those taxpayers who decide not to disclose, we can make paying taxes easier, and the act of avoiding taxes harder. The Treasury Department has a proposal that is very similar to this provision. Both proposals provide incentives for more disclosure of questionable tax planning techniques, increased penalties for non-disclosure of illegal tax planning techniques, as well as avoiding undue burdens on legitimate business planning. I will oppose any amendments to disrupt the balance that the provision attempt to achieve.

However, in many ways, the provisions in the mark are merely treating the symptoms

without addressing the actual disease. The Finance Committee must move forward and take steps to simplify the corporate tax code – that is what's at stake here. Medium to large companies are under a huge burden to comply with needlessly complicated tax laws. For example, IRS employees are routinely provided office space for the sole purpose of auditing companies, 365 days a year. This is a sure sign that the system is too complicated and needs immediate attention. And, parenthetically, a subtle but very unhealthy effect of such cohabitation is the cozy relationships that will develop; it was in this atmosphere that our "creative accounting" financial scandals flourished. This bill should aim to bring us back to basics: it should provide taxpayers and their advisors with knowledge, and certainty, about their obligations under the new regime; the goal should be increased compliance, not further complication, nor further opportunities for "creative accounting."

Sadly, the mark fails to apply this common sense principle when it comes to the provision on the tax treatment of inversion transactions. The issue of inversions, the very fact that we are debating it today, bespeaks a fundamental confusion about our entirely too complex tax code. The provision in the mark is primarily intended to strengthen current law, which imposes the corporate-level "toll charge" for moving assets out of the U.S. taxing jurisdiction. This is not the answer. Our current international provisions are overly punitive and provide a competitive advantage to foreign companies, at the expense of U.S. companies. These laws should not be strengthened, but reformed entirely. Is it any wonder that so many U.S. companies find it attractive to relocate to low-tax jurisdictions to avoid U.S. tax on foreign earnings? Of course not.

The Finance Committee must step forward and lead on these issue. Despite this problem, as well as the WTO ruling that our laws governing certain exporting companies constitute an illegal export subsidy, there have not been any hearings on our international tax laws. This stands in sharp contrast to the manner in which this committee addressed legislation to curb unfair corporate tax shelters. Hearings should focus on ways to minimize the complications of our international tax system, moving away from the current "worldwide" system of taxation and towards a "territorial" system. This is a complicated area of the tax law that has an enormous impact on our businesses' international competitiveness. Today, this committee is forced to vote on legislation with too little information that treats only a symptom of the underlying disease -- the lack of a fair and appropriate international tax code. Consequently, I stand ready to improve this provision if appropriate amendments are offered during this mark-up.

Mr. Chairman, I would now like to take a moment to explain an amendment I will be offering to this mark. As it stands, the mark provides no specific incentives for charitable giving to education. I believe that is a crucial omission – and one that should be rectified.

In our campaigns, most of us have pledged to make elementary and secondary education a top priority. The reason is simple. We know that almost any of the social problems facing our nation would be ameliorated by improvement in educational outcomes. And we know that better education means more economic prosperity and scientific progress. So while we work to increase incentives for charitable giving, I believe we should try especially hard to spur giving that will affect elementary and secondary education. And in this effort, I believe we should look

to states that have enacted innovative measures to promote giving for education through the tax code.

Many of you know that Arizona and a number of other states have implemented incentives like this and the results have been impressive. Let's start with Arizona. My state's credit has allowed 19,000 Arizona students -- most of them from needy families -- to receive scholarships to attend a school of choice. The reason: Arizonans donated more than $32 million to one or more of the 30 scholarship-granting organizations in our state. Most of those organizations came into being only after the incentives were enacted. In Pennsylvania, thanks to that state's new corporate tax credit, more than 900 businesses have committed almost $19 million to the 75 nonprofit scholarship organizations that now operate there, which will make it possible for some 10,000 poor students attend schools of choice this year. And a new tax credit in Florida – also a corporate credit – is expected to distribute more than 14,000 scholarships to poor students before year's end.

The measure I am proposing today is much more modest than these bold approaches in these three states, and more modest than what I have proposed in the past. It provides a partial – 50 percent – credit for donations that individuals and corporations make for educational purposes. The amount of donations subject to the credit would be $250 for individuals ($500 for couples filing jointly) and $50,000 for corporations. To claim the credit, taxpayers could donate directly to a school, or they could donate to an organization that gives scholarships to elementary and secondary students.

What are the benefits of this amendment? First, it will provide parents with more choices. There are a couple of important facets to this choice: Parents should have a right to get the best education possible for their children as they see it. And, if we are serious about securing improved education, we should bring to bear the forces of competition that have spurred excellence in other areas of endeavor. A second advantage: this amendment allows us to aid education without adding to the bureaucracy in Washington and without adding new mandates with which educators in our communities will have to contend. Perhaps for some, this is a disadvantage, but I would argue strenuously that it is an important advantage. Third, my amendment is neutral as between public and private education. Credits could be claimed for donations to public or private schools. And scholarships could be used to offset tuition costs at a private school, or to pay the tuition costs families in most states must pay to enroll a child in a school across district boundaries.

Finally, my amendment is imbued with the spirit of the Care Act. That is, it uses the tools of public policy to solve a pressing social problem -- in this case, the failure of our education system to keep its promise to many of our children, but it does so by mobilizing the armies of compassion.

I am looking forward to debate and discussion, as well as the opportunity for Members to offer their own suggestions and insights into ways that charitable giving can be expanded and encouraged through appropriate federal action. I support the CARE Act's goals and I am confident that the Finance Committee will be able to correct a number of the bill's flaws, while

also improving upon its strengths. When this occurs, I am ready to lend my support to ensure that it makes its way to the President's desk for signature.

DESCRIPTION OF THE "CARE ACT OF 2002"

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

June 11, 2002
JCX-57-02

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of the "CARE Act of 2002". This document[1], prepared by the staff of the Joint Committee on Taxation, provides a description of the "CARE Act of 2002."

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "CARE Act of 2002"* (JCX-57-02), June 11, 2002.

I. CHARITABLE GIVING INCENTIVES

A. Charitable Deduction for Nonitemizers

Present Law

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3)[2] or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[3]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[4]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[5] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity

[2] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[3] Secs. 170(b) and (e).

[4] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[5] Sec. 170(f)(8).

and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[6]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal would allow a direct charitable deduction from adjusted gross income for charitable contributions paid in cash. This deduction would be allowed in addition to the standard deduction. The deduction would be available only for that portion of contributions that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction would be $250 ($500 in the case of a joint return). For example, an individual would not be entitled to a charitable deduction for the first $250 of cash contributions made during the tax year, would be entitled to a deduction on a dollar-for-dollar basis for contributions of $251 to $500 (e.g., a $1 contribution deduction in the case of $251 of contributions, and a $250 deduction in the case of $500 of contributions), and would not be entitled to a deduction for any contributions exceeding $500. The direct charitable deduction generally would be subject to the tax rules normally

[6] Sec. 6115.

governing charitable contribution deductions, such as the substantiation requirements. The deduction would be allowed in computing alternative minimum taxable income.

The Secretary of the Treasury would be required to complete a study by December 31, 2003, of the effect of the proposal on increased charitable giving, and of taxpayer compliance, for example, by comparing compliance by taxpayers who itemize their charitable contributions with compliance by those who claim the direct charitable deduction.

Effective Date

The direct charitable deduction would be effective for taxable years beginning after December 31, 2001, and before January 1, 2004. The Treasury study would be required by December 31, 2003.

B. Tax-Free Distributions From Individual Retirement Arrangements for Charitable Purposes

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[7]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[8]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[9] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods

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[7] Secs. 170(b) and (e).

[8] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[9] Sec. 170(f)(8).

or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[10]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[11] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[12] For

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[10] Sec. 6115.

[11] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[12] Sec. 170(f)(2).

such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[13] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[14] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[15] also are required to file Form 1041A. The

[13] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[14] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[15] Sec. 642(c).

returns are required to be made publicly available.[16] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[17] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

Qualified charitable distributions from IRAs

The proposal would provide an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Special rules would apply in determining the amount of an IRA distribution that would be otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions would continue to apply to distributions from an IRA that are not qualified charitable distributions.

A qualified charitable distribution would be defined as any distribution from an IRA that is made directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity would mean a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions would be eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2. Distributions to a split interest entity would be eligible for the exclusion only if made on or after the date the IRA owner attains age 59-1/2. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, his or her spouse, or a charitable organization.

The exclusion would apply to direct distributions only if a charitable contribution deduction for the entire distribution would otherwise be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount would be reduced because of a benefit received in exchange, or if a deduction would not be allowable because the donor did not obtain sufficient substantiation, the exclusion would not be available with respect to any part of the distribution. Similarly, the exclusion would apply in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) would be allowable, determined without regard to the generally applicable percentage limitations.

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[16] Sec. 6104(b).

[17] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

If the IRA owner has any IRA that includes nondeductible contributions, a special rule would apply in determining the portion of a distribution that would be includible in gross income (but for the proposal) and thus is eligible for qualified charitable distribution treatment. In such case, the IRA owner would aggregate all IRAs to determine eligibility for the exclusion. Under the special rule, the distribution would be treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the proposal) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions during the year that is includible in income. In determining the amount of subsequent IRA distributions includible in income, proper adjustments would be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules would apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the proposal would provide that subsequent distributions from the charitable remainder trust would be treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally would be treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust would have to be funded exclusively by such distributions. For example, an IRA owner would not be able to make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the proposal, a pooled income fund would be eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions would be treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund would not be includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity would not be an investment in the annuity contract.

Any amount excluded from gross income by reason of the proposal would not be taken into account in determining the deduction for charitable contributions under section 170.

<u>Split-interest trust filing requirements</u>

The proposal would increase the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information, and would impose personal liability for such penalty on certain persons in certain circumstances. The penalty would be $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty would be $100 for each day the failure continues up to a maximum of $50,000. If a person (meaning any officer, director, trustee, employee, or other individual who is

under a duty to file the return or include required information)[18] knowingly failed to file the return or include required information, then that person would personally be liable for such penalty. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) would be exempt from the requirement to make information publicly available. In addition, the proposal would repeal the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception would remain available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 2002. The provision relating to information returns of split-interest trusts would be effective for returns for taxable years beginning after December 31, 2002.

[18] Sec. 6652(c)(4)(C).

C. Charitable Deduction for Contributions of Food Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[19] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[20]

Description of Proposal

Under the proposal, any taxpayer, whether or not a C corporation, engaged in a trade or business would be eligible to claim an enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year could not exceed 10 percent of the taxpayer's net income for such year from its trade or business. In addition, a non-C corporate taxpayer would be required to apply separately carryforwards of contributions of food inventory and other charitable contributions.

The proposal would change the amount of the present-law enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value). Under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Under present law,

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[19] Sec. 170(e)(3). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income. Sec. 170(b)(2).

[20] *Lucky Stores Inc. v. Commissioner,* 105 T.C. 420 (1995).

taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.) Taxpayers that do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A would be able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[21]

The enhanced deduction would be available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" would be defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

In addition, the proposal would provide that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market would be determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

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

[21] This would include, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002-28 and 2001-10.

D. Charitable Deduction for Contributions of Book Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[22] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

Description of Proposal

The proposal would modify the present-law enhanced deduction for C corporations so that it would be equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. For example, a C corporation that made a qualified book contribution with a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value).

A qualified book contribution would mean a charitable contribution of books to: (1) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), which is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (2) not transfer the property in exchange for money, other property, or services; (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

Effective Date

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

[22] Sec. 170(e)(3).

E. Charitable Deduction for Contributions of Bonds

Present Law

Under present law, a taxpayer's deduction for charitable contributions of property, including a contribution of bonds, to or for the use of a private foundation (other than a private foundation described in section 170(b)(1)(E)) generally is limited to the taxpayer's basis in the property. As an exception to the general rule, a taxpayer's deduction for charitable contributions of qualified appreciated stock for the use of such a private foundation generally is the fair market value of the stock.[23]

Description of Proposal

The proposal would provide for a fair market value deduction for charitable contributions of qualified appreciated bonds to or for the use of a private foundation (other than a private foundation described in section 170(b)(1)(E)). The proposal would define qualified appreciated bonds as United States Treasury securities and such other debt instruments as may be prescribed by the Secretary in regulations.

Effective Date

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

[23] Sec. 170(e)(5)(A).

F. Expand Charitable Contribution Allowed for Scientific Property Used for Research and for Computer Technology and Equipment

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[24]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[25] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and be used substantially for research or experimentation, or for research training, in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is

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[24] Sec. 170(e)(1).

[25] Secs. 170(e)(4) and 170(e)(6).

substantially completed.[26] The original use of the property must be by the donor or the donee,[27] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[28]

Description of Proposal

Under the proposal, property assembled by the taxpayer, in addition to property constructed by the taxpayer, would be eligible for either enhanced deduction.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

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

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

[28] Sec. 170(e)(6)(C).

G. Encourage Contributions of Capital Gain Real Property Made for Conservation Purposes

Present Law

Charitable contributions generally

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. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[29]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

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 to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain

[29] Secs. 170, 2055, and 2522, respectively.

property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryforward rules of other charitable contributions of capital gain property.

Description of Proposal

In general

Under the proposal, the 30-percent contribution base limitation on contributions of capital gain property by individuals would not apply to qualified conservation contributions (as defined under present law). Thus, individuals could include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation. In addition, individuals would be allowed to carryforward any qualified conservation contribution that exceeds the 50-percent limitation for 15 years.

The 50-percent contribution base limitation would apply first to contributions other than qualified conservation contributions and then to qualified conservation contributions. For example, an individual with a contribution base of $100 who made a qualified conservation contribution of $80 and other charitable contributions of $60 would be eligible to deduct $50 of the other contributions (50 percent of the $100 contribution base) and carryforward the excess $10 for 5 years, and would be required to carryforward the entire $80 qualified conservation

contribution for 15 years. (By way of illustration, a reverse ordering rule would have limited the deduction to $50 for the qualified conservation contribution, leaving a $30 qualified conservation contribution carryforward for 15 years and $60 of other charitable contributions that could be carried forward for 5 years.)

Farmers and ranchers

In the case of an eligible farmer or rancher, a qualified conservation contribution would be allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule would apply both to individuals and corporations. In addition, corporate (and non-corporate) eligible farmers and ranchers would be allowed to carryforward any excess qualified conservation contributions for 15 years. The 100-percent contribution base limitation would apply first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, an individual with a contribution base of $100 who made a qualified conservation contribution of $80 and other charitable contributions of $60 would be eligible to deduct $50 of other contributions (50 percent of the $100 contribution base) and carryforward the excess $10 for 5 years, and would be able to deduct $50 of the qualified charitable contribution and carryforward the remaining $30 qualified conservation contribution for 15 years.

For this purpose, an eligible farmer or rancher would mean a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

Effective Date

The proposal would be effective for contributions made in taxable years beginning after December 31, 2002.

H. 25 Percent Exclusion for Sales Made for Qualifying Conservation Purposes

Present Law

Gain from the sale or exchange of land held more than one year generally is treated as long-term capital gain.

Generally the net capital gain of an individual (i.e., long-term capital gain less short-term capital loss) is subject to a maximum rate of 20 percent.

Description of Proposal

The proposal would provide a 25-percent exclusion from gross income of capital gain from the qualifying sale of land, or an interest in land or water, provided the land, or interest in land or water, has been held by the taxpayer or the taxpayer's family at all times during the five year period preceding the date of sale. The exclusion would not be available for sales or exchanges of ordinary income property or improvements. Only sales or exchanges of: (1) the entire interest of the taxpayer other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use which may be made of the land or interest in land or water, would qualify for the exclusion. A qualifying sale would be a sale or exchange (excluding a transfer made by order of condemnation or eminent domain or under imminence thereof) to an agency or department of the Federal Government, a State government, or a local government or a section 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be a qualifying sale, the person acquiring the land, or interest in land or water, must provide the taxpayer with a letter stating that the intent of the purchase is to further a qualified conservation purpose and that any subsequent transfer of the acquired interest will protect the conservation purpose in perpetuity. A qualified conservation purpose is: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State or local governmental conservation policy and will yield a significant public benefit.

Under the proposal, the exclusion would be available for capital gain from certain sales or exchanges of a controlling stock interest (generally a stock interest of at least 90 percent of the total voting power and total value of the corporation's stock) in a corporation if at least 90 percent of the fair market value of the corporation's assets at all times during the three year period preceding the sale consisted of land or interests in land. Only controlling stock interests held by the taxpayer or the taxpayer's family at all times during the five years preceding the sale would qualify for the 25-percent exclusion.

Effective Date

The proposal would be effective for sales made after December 31, 2003.

I. Cost Sharing Payments under the Partners for Fish and Wildlife Program

Present Law

Under present law, gross income does not include the excludable portion of payments made to taxpayers by federal and state governments for a share of the cost of improvements to property under certain conservation programs. These programs include payments received under (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act, (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977, (3) the water bank program authorized by the Water Bank Act, (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978, (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act, (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act, (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act, (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978, (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8), and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Description of Proposal

The proposal would expand the types of qualified cost-sharing payments to include payments under the Partners for Fish and Wildlife Program.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2002.

J. Adjust Basis of S Corporation Stock for Certain Charitable Contributions

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining the shareholder's own income tax liability.[30] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[31]

Description of Proposal

The proposal would provide that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation would be an amount equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[32]

Under present law, if an S corporation makes a charitable contribution of appreciated property, the shareholder is taxed on an amount equal to the appreciation in the contributed property when the stock in the S corporation is sold. Under the proposal, the basis in the S corporation stock would be adjusted so that on the sale of the S corporation stock, there would be no tax on the appreciation in the contributed property. The tax consequences under the proposal would be the same as if the individual taxpayer contributed the property directly to the charity without using an S corporation.

Thus, if an S corporation with one shareholder contributes stock with a cost basis of $200 and a fair market value of $500 to a charitable organization, the shareholder would be treated as having made the contribution for purposes of computing the shareholder's charitable contribution deduction (which generally would be $500, assuming section 170(e)(1) does not apply), and the shareholder would reduce the adjusted basis in the S corporation stock by $200. When the shareholder sells the S corporation stock, the shareholder would not recognize gain as a result of the charitable contribution because the basis reduction in the S corporation stock would have been equal to the basis in the contributed property. This is the same result as if a taxpayer contributed such stock directly to a charitable organization -- the taxpayer would receive the same deduction ($500) and would not recognize gain. By contrast, under present law, the shareholder reduces the adjusted basis in the S corporation stock by $500, not $200 as under the proposal, and therefore is taxed on the $300 appreciation as a result of the charitable contribution when the shareholder sells the S corporation stock.

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[30] Sec. 1366(a)(1)(A).

[31] Sec. 1367(a)(2)(B).

[32] Rev. Rul. 96-11 (1996-1 C.B. 140) reaches a similar result in the case of charitable contributions made by a partnership.

Effective Date

The proposal would apply to contributions made in taxable years beginning after December 31, 2002.

II. DISCLOSURE OF INFORMATION RELATING TO TAX-EXEMPT ORGANIZATIONS

A. Disclosure of Written Determinations

Present Law

In general

Three provisions of present law govern the disclosure of information relating to tax-exempt organizations. First, section 6103 provides a general rule that tax returns and return information generally are not subject to public disclosure.[33] Second, in order to allow the public to scrutinize the activities of tax-exempt organizations, section 6104 grants an exception to the confidentiality rule of section 6103 for certain categories of tax-exempt organization documents and information. Section 6104 permits the release in unredacted form of approved applications for tax-exempt status, certain related documents, and annual information returns filed by tax-exempt organizations. As a general rule, to the extent section 6104 specifically provides for the disclosure of tax-exempt organization information, other disclosure provisions do not apply. If tax-exempt organization information does not come within the scope of section 6104, other disclosure provisions will govern whether the information may be disclosed. Third, section 6110 provides that written determinations by the IRS and related background file documents generally are open to public inspection in redacted form. Section 6110 does not apply to any matter to which section 6104 applies.[34]

Disclosure of applications for recognition of tax exemption and annual information returns

Under present law, tax-exempt organizations are required to make a copy of their application for recognition of tax-exempt status (and certain related documents)[35] and their annual information return (Form 990 or Form 990-PF) available for public inspection.

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[33] Sec. 6103(a). A "return" includes any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for, or permitted under the provisions of the Code, which is filed with the IRS. Sec. 6103(b)(1). "Return" also includes any amendment or supplement to the filed return. Sec. 6103(b)(1). "Return information" is defined broadly to include any data received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense under the Code. The term "return information" does not include data in a form that cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. Sec. 6103(b)(2).

[34] Sec. 6110(l)(1).

[35] Section 6104(a)(1)(A) provides that "any papers submitted in support of" an application for tax-exempt status must be available for inspection. Treasury regulations limit the definition of supporting documents to papers submitted by the organization. Treas. Reg. sec. 301.6104(a)-1(e).

Organizations are not required to disclose an application for tax exemption filed by the organization unless the IRS responded favorably to the application.[36] Charitable organizations that are not classified as private foundations are not required to disclose the names of donors to the organization.

The Secretary may withhold disclosure of certain information described in an organization's application for tax-exempt status if disclosure would: (1) divulge a trade secret, patent, process, style of work, or apparatus of the organization, and the Secretary determines that such disclosure would harm the organization; or (2) that the Secretary determines would harm the national defense.[37] The organization must apply to the Commissioner for a determination that the disclosure would violate one of these criteria. The organization will be given 15 days to contest an adverse determination before the information is made available for public inspection.[38]

<u>**Disclosure of written determinations**</u>

Section 6110 provides that the text of any written determination by the IRS and related background file document is open to public inspection.[39] The term "written determination" means a ruling,[40] determination letter,[41] technical advice memorandum,[42] or Chief Counsel advice.[43] Closing agreements, which are final and conclusive written agreements entered into by

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[36] Treas. Reg. sec. 301.6104(d)-1(b)(3)(iii)(A).

[37] Sec. 6104(a)(1)(D). In the case of a pension plan, information may be withheld if it would identify any particular individual covered under the plan. *Id.*

[38] Treas. Reg. sec. 301.6104(a)-5(a)(1).

[39] Sec. 6110(a).

[40] A ruling is a written statement issued by the National Office to a taxpayer or his or her authorized representative. Treas. Reg. sec. 301.6110-2(d). It generally recites the relevant facts, sets forth the applicable provisions of law, and shows the application of the law to the facts. Treas. Reg. sec. 301.6110-2(d).

[41] A district director issues a "determination letter" in response to a written inquiry from an individual or organization that applies principles and precedents previously announced by the IRS National Office to the particular facts involved. Treas. Reg. sec. 301.6110-2(e).

[42] A "technical advice memorandum" is a written statement issued by the IRS National Office to a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. Treas. Reg. sec. 301.6110-2(f). Generally, a technical advice memorandum states the relevant facts, sets forth the applicable law, and states a legal conclusion. Treas. Reg. sec. 301.6110-2(f).

[43] Sec. 6110(b)(1). Any IRS National Office component of the Office of Chief Counsel can issue Chief Counsel advice. The IRS National Office component issues the advice to IRS field or service center employees, or to regional or district employees of Chief Counsel. Sec.

the IRS and a taxpayer in order to settle the taxpayer's tax liability with respect to a taxable year, do not constitute written determinations.[44] A background file document includes the request for a written determination, any written material submitted by the taxpayer in support of the request, and any communications between the IRS and other persons in connection with the written determination received before issuance of the written determination.[45]

A background file document is available upon written request to any person requesting a copy of the related written determination.[46] Before releasing any written determination or background file document, the IRS must delete identifying details of the person about whom the written determination pertains and certain other information.[47] With respect to tax-exempt organizations, disclosure under section 6110 is limited to letters and rulings unrelated to an organization's tax-exempt status.[48]

The application of section 6110 to guidance relating to tax-exempt organizations is limited. Section 6110(l)(1) provides, "this section shall not apply to any matter to which section

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6110(i)(A)(i). The definition of Chief Counsel advice does not encompass advice issued from one IRS National Office component of the Office of Chief Counsel to another. The advice by definition conveys: (1) a legal interpretation of a revenue provision; (2) the IRS or Chief Counsel position or policy concerning a revenue provision; or (3) a legal interpretation of any law (Federal, State, or foreign) relating to the assessment or collection of liability under a revenue provision. Sec. 6110(i)(A)(ii).

[44] Sec. 6103(b)(2)(D); sec. 6110(b)(1)(B).

[45] Sec. 6110(b)(2). Communications between the IRS and the Department of Justice relating to a pending civil or criminal case are not considered background file documents.

[46] Sec. 6110(e).

[47] Sec. 6110(c) provides the following exemptions from disclosure: (1) the names, addresses, and other identifying details of the person to whom the written determination pertains and of any other person, other than a person with respect to whom a notation is made under subsection (d)(1) (relating to third party contacts), identified in the written determination or any background file document; (2) information specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified pursuant to such Executive order; (3) information specifically exempted from disclosure by any statute (other than this title) which is applicable to the Internal Revenue Service; (4) trade secrets and commercial or financial information obtained from a person and privileged or confidential; (5) information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy; (6) information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and (7) geological and geophysical information and data, including maps, concerning wells.

[48] Sec. 6110(l)(1); Treas. Reg. sec. 301.6110-1(a).

6104 applies." The regulations under section 6110 clarify which matters are within the ambit of section 6104 and, therefore, are not subject to disclosure under section 6110:

"[a]ny application filed with the Internal Revenue Service with respect to the qualification or exempt status of an organization . . .; any document issued by the Internal Revenue Service in which the qualification or exempt status of an organization is . . . granted, denied or revoked or the portion of any document in which technical advice with respect thereto is given to a district director; . . . the portion of any document issued by the Internal Revenue Service in which is discussed the effect on the qualification or exempt status of an organization . . . of proposed transactions by such organization . . . ; and any document issued by the Internal Revenue Service in which is discussed the qualification or status of a [private foundation or private operating foundation]."[49]

In addition, the regulations under section 6104 provide that some determination letters and other documents relating to tax exemption that are not open to public inspection under section 6104(a)(1)(A) are nevertheless "within the ambit" of section 6104 for purposes of the disclosure provisions of section 6110.[50] The regulation explains that the following documents are, therefore, not available for public inspection under either section 6104 or 6110:

(1) unfavorable rulings or determination letters issued in response to applications for tax exemption;

(2) rulings or determination letters revoking or modifying a favorable determination letter;

(3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;

(4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503;

(5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and

(6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c), does not relate to that organization's application for tax exemption.[51]

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[49] Treas. Reg. sec. 301.6110-1(a).

[50] Treas. Reg. sec. 301.6104(a)-1(i).

[51] *Id.*

The effect of these limitations is that written determinations relating to exempt status issues are not released, even in redacted form. The IRS does, however, release written determinations issued to tax-exempt organizations that include issues that clearly are not within the ambit of section 6104, such as the application of the unrelated business income tax to a particular proposed transaction.

Description of Proposal

The proposal would require disclosure in redacted form of written determinations relating to the tax-exempt status of an organization described in section 501(c) or (d) that are not required to be disclosed by section 6104(a)(1)(A) but that are within the scope of section 6104. Such written determinations (and related background file documents) would be disclosed under the provisions of section 6110 and would include: (1) unfavorable rulings or determination letters issued in response to applications for tax exemption; (2) rulings or determination letters revoking or modifying a favorable determination letter; (3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter; (4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503; (5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and (6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c) or (d), does not relate to that organization's application for tax exemption.

Effective Date

The proposal would be effective for written determinations issued after December 31, 2002.

B. Disclosure of Internet Web Site and Name Under Which Organization Does Business

Present Law

Most types of tax-exempt organizations are required to file annually an information return.[52] The Internal Revenue Code does not require an exempt organization to furnish on the applicable information return any name under which the organization operates or does business, if such name differs from the legal name of the organization, or the organization's Internet web site address, if any.[53]

Description of Proposal

The proposal would require a tax-exempt organization subject to reporting requirements under section 6033(a) to include on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

Effective Date

The proposal would be effective for returns filed after December 31, 2002.

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[52] Sec. 6033(a). *See, e.g.*, Form 990 -- Return of Organization Exempt From Income Tax. An organization that is required to file Form 990, but that has gross receipts of less than $100,000 during its taxable year, and total assets of less than $250,000 at the end of its taxable year, may file Form 990-EZ instead of Form 990. Private foundations are required to file Form 990-PF rather than Form 990.

[53] The IRS requires disclosure of an organization's Internet web site address on Forms 990 and 990-EZ.

C. Modification to Reporting of Capital Transactions

Present Law

Private foundations are required to file an annual information return (Form 990-PF).[54] Part IV of the Form 990-PF requires that private foundations report detailed information regarding the gain or loss from the sale or other disposition of property, including a description of the property sold, how it was acquired (purchase or donation), the date acquired, the date sold, the gross sales price, the amount of depreciation allowed or allowable, and the cost or other basis plus expenses of the sale. Such information generally is required for the IRS to calculate the tax on the private foundation's net investment income. The Form 990-PF is required to be made available to the public.

Description of Proposal

The proposal would require that any information regarding capital gains and losses that is required to be furnished by private foundations in order to calculate the tax on net investment income would be furnished also in summary form. Any such information regarding capital gains and losses that is required to be filed with the IRS but that is not in summary form would not be required to be made available to the public except by the explicit request of a member of the public to the organization or to the IRS. Private foundations would be required to state on the furnished summary that the more detailed description is available upon such request.

Effective Date

The proposal would be effective for returns filed after December 31, 2002.

[54] Sec. 6033(a).

D. Disclosure that Form 990 is Publicly Available

Present Law

Under present law, there is no requirement that the IRS notify the public that the Form 990 is publicly available.

Publication 17 (Your Federal Income Tax), Publication 526 (Charitable Contributions), and the Instructions to Schedule A (Itemized Deductions) of Form 1040 do not advise that an exempt organization's Form 990 is publicly available.

Description of Proposal

The proposal would require the IRS to notify the public in Publication 17, Publication 526, and the Instructions to Schedule A of Form 1040 that an exempt organization's Form 990, Form 990-EZ, and Form 990-PF are publicly available.

Effective Date

The proposal would be effective for instructions or publications issued or revised after the date of enactment.

E. Disclosure to State Officials of Proposed Actions Related to Section 501(c)(3) Organizations

Present Law

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[55] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, return and return information (as such terms are defined in sec. 6103(b)) is confidential and may not be disclosed or inspected unless expressly provided by law.[56] Present law requires the Secretary to keep records of disclosures and requests for inspection[57] and requires that persons authorized to receive return and return information maintain various safeguards to protect such information against unauthorized disclosure.[58] Willful unauthorized disclosure or inspection of return or return information is subject to a fine and/or imprisonment.[59] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[60] Such present-law protections against unauthorized disclosure or inspection of return and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

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[55] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[56] Sec. 6103(a).

[57] Sec. 6103(p)(3).

[58] Sec. 6103(p)(4).

[59] Secs. 7213 and 7213A.

[60] Sec. 7431.

Description of Proposal

The proposal provides that upon written request by an appropriate State officer, the Secretary may disclose, with respect to a section 501(c)(2) (certain title holding companies), 501(c)(3) (charitable and similar organizations), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies) organization: (1) a notice of proposed refusal to recognize an organization as an organization exempt from tax; (2) a notice of proposed revocation of tax-exemption; (3) with respect to private foundations, the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names and taxpayer identification numbers of organizations that have applied for recognition as tax-exempt organizations; and (5) return and return information of organizations[61] with respect to which information has been disclosed under (1) through (4) above. Disclosure or inspection would be permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating the applicable tax-exempt organization, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Disclosure or inspection could be made only to or by designated representatives of the appropriate State officer, which includes officers, employees, agents, and contractors of the appropriate State officer. The Secretary also would be permitted to disclose or open to inspection the return and return information of an organization that is recognized as tax-exempt under sections 501(c)(2), 501(c)(3), 501(c)(4), 501(c)(6), 501(c)(7), 501(c)(8), 501(c)(10), and 501(c)(13), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal and State issues relating to the organization. Appropriate State officer would mean the State attorney general or the head of any State agency, body, or commission that is charged under the laws of such State with responsibility for overseeing organizations of the type described in the applicable section.

In addition, the proposal would provide that return and return information disclosed under section 6104(c) may be disclosed in civil administrative and judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information would not be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The proposal would make disclosures of returns and return information under section 6104(c) subject to many of the provisions of section 6103, including that such information remain confidential (sec. 6103(a)(2)), that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)), and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The proposal would provide that the willful unauthorized disclosure of return or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of return or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one

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[61] Such information also may be open to inspection by an appropriate State officer.

year (sec. 7213A), and would provide the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

Effective Date

The provision would be effective on the date of enactment but would not apply to requests made before such date.

III. OTHER CHARITABLE AND EXEMPT ORGANIZATION PROVISIONS

A. Modify Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts

Present Law

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.[62]

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[63]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[64]

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[65]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not

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[62] Treas. Reg. sec. 1.664-1(d)(2).

[63] Sec. 664(b).

[64] Treas. Reg. sec. 1.664-1(d)(4).

[65] Sec. 664(d).

qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Description of Proposal

The proposal would impose a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This would replace the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Consistent with present law, the tax would be treated as paid from corpus. The unrelated business taxable income would be considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

B. Modify Section 512(b)(13)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's UBI and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal would provide that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's UBI, applies only to the portion of payments received in a taxable year that exceed the amount of the specified payment that would have been paid if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's UBI. In addition, the proposal would impose a 20 percent penalty on the excess amount of any such payment.

The proposal would provide that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also would not apply to amounts received or accrued under such contract before January 1, 2001.

Effective Date

The proposal would apply to payments received or accrued after December 31, 2000.

C. Simplification of Lobbying Expenditure Limitation

Present Law

In general

An organization does not qualify for tax-exempt status under section 501(c)(3) unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[66] Carrying on propaganda and attempting to influence legislation commonly are referred to as "lobbying" activities. Thus, section 501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both. Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[67] which consists of bright-line rules that specify the dollar amount of permitted expenses on lobbying activities.

Consequences of excess lobbying under section 501(h)

Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[68]

The expenditure limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[69] The grass-roots nontaxable amount is 25 percent of the organization's

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[66] Sec. 501(c)(3).

[67] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[68] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[69] Exempt purpose expenditures generally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income

lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[70] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[71]

Definitions

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[72] For a communication to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[73] A communication includes a call to action if it incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[74] In

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tax, or capital expenses in connection with an unrelated business. See Treas. Reg. sec. 56.4911-4.

[70] Sec. 501(h)(1).

[71] Treas. Reg. sec. 1.501(h)-3.

[72] Secs. 501(h)(2)(C) & 4911(d)(1)(A).

[73] Treas. Reg. sec. 56.4911-2(b)(2)(i).

[74] Treas. Reg. sec. 56.4911-2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911-2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911-5(e).

addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[75] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard to the timing of the legislation (a customary course of business exception).[76]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[77] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[78]

Special rules for mixed lobbying expenditures

Expenses that serve both direct and grass-roots lobbying purposes, e.g., communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[79] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also

[75] Treas. Reg. sec. 56.4911-2(b)(5)(ii).

[76] *Id.*

[77] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911-2(b)(1).

[78] Sec. 4911(d)(2).

[79] Treas. Reg. sec. 56.4911-5(e).

encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

Disclosure of lobbying expenditures

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include: (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[80]

Description of Proposal

The proposal would eliminate the separate limitation for grass-roots lobbying expenditures applicable to electing charities. Electing charities would remain subject to the overall limitation on lobbying expenditures, which would not change in amount, but electing charities would not be required to limit grass roots expenditures as a percentage of overall lobbying. Thus, an electing charity would be able to make tax-free any combination of grass-roots and direct lobbying expenditures up to the lobbying non-taxable amount and would not risk loss of tax-exemption until total lobbying expenditures normally exceeded the lobbying ceiling amount. For purposes of the section 501(h) election, electing charities would no longer be required to distinguish between grass-roots lobbying and direct lobbying, whether for mixed lobbying expenditures or otherwise.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

[80] *See* Treas. Reg. sec. 56.4911-6.

D. Expedited Review Process for Certain Tax-Exemption Applications

Present Law

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[81] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12-month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

Description of Proposal

The proposal would allow expedited consideration of applications for exempt status by organizations that are organized and operated for the primary purpose of providing social services. To be eligible, the organization must: (1) be seeking a contract or grant under a Federal, State, or local program that provides funding for social service programs; (2) establish that tax-exempt status is a condition of applying for such contract or grant; (3) include a completed copy of the contract or grant application with the application for exemption; and (4) meet such other criteria as the Secretary may provide. Organizations that meet the eligibility requirements described above (except for the requirement that tax-exempt status is a condition of the contract or grant application), and that certify that the organization's average annual gross receipts over the four year period preceding the application (or during the organization's first four years) was not more than $50,000 would be entitled to a waiver of any fee for application of tax-exempt status.

For this purpose, social services would be defined as services directed at helping people in need, reducing poverty, improving outcomes of low-income children, revitalizing low-income communities, and empowering low-income families and low-income individuals to become self-sufficient, including: (1) child care services, protective services for children and adults, services for children and adults in foster care, adoption services, services related to the management and maintenance of the home, day care services for adults, and services to meet the special needs of children, older individuals, and individuals with disabilities (including physical, mental, or emotional disabilities); (2) transportation services; (3) job training and related services, and employment services; (4) information, referral, and counseling services; (5) the preparation and delivery of meals, and services related to soup kitchens or food banks; (6) health support services; (7) literacy and mentoring programs; (8) services for the prevention and treatment of juvenile delinquency and substance abuse, services for the prevention of crime and the provision

[81] Sec. 508(a).

of assistance to the victims and the families of criminal offenders, and services related to the intervention in, and prevention of, domestic violence; and (9) services related to the provision of assistance for housing under Federal law. Social services does not include a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 or under the Higher Education Act of 1965.

Effective Date

The proposal would be effective for applications for tax-exempt status filed after December 31, 2002.

E. Clarification of Definition of Church Tax Inquiry

Present Law

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[82] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

Description of Proposal

The proposal would clarify that the present-law church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the law governing tax-exempt organizations. For example, the proposal would clarify that the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

Effective Date

The proposal would be effective on the date of enactment.

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[82] Sec. 7611. Prior to the year 2000 IRS restructuring, the lowest level official who could initiate a church tax inquiry was an IRS Regional Commissioner.

F. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which 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 status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable

years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. The provision would limit jurisdiction over controversies involving such determinations to the United States Tax Court.[83]

Effective Date

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations would be effective for pleadings with respect to determinations made after December 31, 2001.

[83] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

G. Definition of Convention or Association of Churches

Present Law

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[84] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[85] and is subject to certain other provisions generally applicable to churches.[86] The Internal Revenue Code does not define the term "convention or association of churches."

Description of Proposal

The proposal would provide that an organization that otherwise is a convention or association of churches would not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

Effective Date

The proposal would be effective on the date of enactment.

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[84] Sec. 6033(a)(2)(A)(i).

[85] Sec. 7611(h)(1)(B).

[86] *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

H. Charitable Contribution Deduction for Certain Expenses in Support of Native Alaskan Subsistence Whaling

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 (sec. 170). 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 (Treas. Reg. sec. 1.170A-1(g)). 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.

Description of Proposal

The proposal would allow individuals to claim a deduction under section 170 not exceeding $7,500 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction would be 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 would be available for reasonable and necessary expenses paid by the taxpayer during the taxable year for: (1) the 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) storage and distribution of the catch from such activities.

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

Effective Date

The proposal would be effective for contributions made after December 31, 2002.

I. Payments by Charitable Organizations to Victims of War on Terrorism

Present Law

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible.[87] Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation.[88] For example, it is self-dealing if assets of a private foundation are used for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

Description of Proposal

The proposal would provide that organizations described in section 501(c)(3) that make certain payments are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption, provided that the organization makes the payments in good faith and uses an objective formula that is consistently applied in making the payments.

The proposal would apply to payments to a member of the Armed Forces of the United States (as defined in section 7701(a)(15)), or to a member of such person's immediate family, by reason of the death, injury, wounding, or illness of a member of the Armed Forces of the United States that was incurred as a result of the military response of the United States to the terrorist attacks against the United States on September 11, 2001. As under present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, under the proposal, a charitable organization that assists the families of members of the Armed Forces killed in the line of duty would be able to make a pro-rata distribution to the families of those killed, even though the specific financial needs of each family were not directly considered. Similarly, if the amount of a distribution was based on the number of dependents of a charitable class of persons killed in the military response to the attacks and this standard was applied consistently among distributions, the specific needs of each recipient would not have to be taken into account. However, it would not be appropriate for a charity to make pro-rata payments based on the recipients' living expenses before the harm occurred if the result generally would be to provide significantly greater assistance to persons in a better position to

[87] Sec. 170.

[88] Sec. 4941.

provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it would not, under the proposal, be a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need would not be required, payments that would not further public purposes would not be permitted. The proposal would not change the substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement. The proposal also would provide that if a private foundation makes payments under the conditions described above, the payment would not be treated as made to a disqualified person for purposes of section 4941.

Effective Date

The provision applies to payments made after the date of enactment and before September 11, 2003.

IV. RESTORATION OF SOCIAL SERVICES BLOCK GRANT FUNDING

Present Law

Social Services Block Grant Funding ("SSBG"), also known as "Title XX" (because it is Title XX of the Social Security Act), is a flexible funding stream, providing states with resources to support a variety of social services. SSBG funds can be used to assist the elderly and disabled so that they do not need to enter institutions, to prevent child and elder abuse, to provide child care, to promote and support adoption, and for several other services. There are certain specified limitations so that SSBG cannot fund most medical care, for example, or cash welfare payments. It is a mandatory capped entitlement, distributed by a population-based formula among the states.

States use SSBG in differing ways. Much of the funding supports local social service providers, including faith-related organizations, through contracts with state and local governments. Overall, in fiscal year 1999, SSBG spending was as follows: 13.4 percent for "prevention" and case management; 13 percent for day care; 12.4 percent for child and adult protective services; 10.9 percent for foster care; 7.4 percent for home-based services. There are several other categories in the expenditure data as well.

Prior to the 1996 welfare reform law, SSBG was funded at $2.8 billion. That legislation reduced SSBG to $2.38 billion, as part of achieving budgetary savings, and permitted states to transfer up to 10 percent of their new Temporary Assistance for Needy Families (TANF) welfare block grant allocations to SSBG. (Any transferred funds are required to be spent on behalf of families below 200 percent of poverty.) In 1998, as part of the TEA-21 highway legislation, SSBG funding as further reduced, declining to $1.7 billion for fiscal year 2001 and fiscal year 2002. The TANF transfer was further limited to 4.25 percent.

Description of Proposal

The proposal would increase SSBG funding to $1.975 billion for fiscal year 2003 and $2.8 billion for fiscal year 2004. In addition, the TANF transfer limit would be restored to 10 percent. These two measures provide additional resources to faith-related social service organizations. Finally, the Secretary of HHS would be required to submit annual reports on SSBG expenditures to the Congress.

Effective Date

The proposal would be effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports would be with respect to fiscal year 2002 and each fiscal year thereafter.

V. REVENUE RAISING PROPOSALS

A. Tax Shelter Transparency Act

1. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require corporate taxpayers to disclose with their tax return certain information with respect to each "reportable transaction" in which the corporate taxpayer participates.[89]

There are two categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A corporation must disclose any listed transaction that is expected to reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or more than $2 million in any combination of years.[90]

The second category of reportable transactions is transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of $5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.[91]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer's ability to claim that any

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[89] Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4.

[90] Temp. Treas. Reg. sec. 1.6011-4T(b)(2) and -(b)(4)(i).

[91] Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[92]

Description of Proposal

The proposal would create 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 would apply without regard to whether the transaction ultimately results in an understatement of tax and is in addition to any accuracy-related penalty that may be imposed.

The penalty for failing to disclose a reportable transaction 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 could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the disclosure penalties.

A public entity that is subject to a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose[93]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") (for such period as the Secretary shall specify). The proposal would treat any failure to disclose a transaction in reports to the SEC as a failure to disclose a listed transaction.

The proposal would define a "listed transaction" and a "reportable transaction" by reference to the definition given to these terms in Treasury regulations under section 6011. A "large entity" would be 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" would be 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.

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[92] 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.

[93] This category of transactions is described in greater detail below in connection with the proposal to modify the accuracy-related penalty to tax shelters.

Effective Date

The proposal would be effective for returns and statements the due date for which is after the date of enactment.

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[94] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[95]

Special rules apply with respect to tax shelters.[96] 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.[97] 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.[98]

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[94] Sec. 6662.

[95] Sec. 6662(d)(2)(B).

[96] Sec. 6662(d)(2)(C).

[97] Sec. 6664(c).

[98] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

Description of Proposal

The proposal would modify the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new set of rules that would apply to listed transactions and reportable transactions with a significant tax avoidance purpose.[99] The rate of the penalty and the defenses that would be available to avoid the penalty would vary depending on the type of transaction and on whether the transaction was adequately disclosed.

Under the proposal, a 20-percent penalty would apply to any understatement attributable to a listed transaction or a reportable transaction with a significant purpose of tax avoidance. The only exception to the penalty would be the reasonable cause and good faith exception of section 6664(c). Under the proposal, the reasonable cause exception would apply only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed treatment, and the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment.

If the taxpayer does not adequately disclose the transaction, the reasonable cause and good faith exception would not be available, and a higher penalty rate would apply. If the understatement is attributable to an undisclosed listed transaction, the penalty rate would be increased to 30 percent. For understatements attributable to an undisclosed reportable transaction with a significant tax avoidance purpose, the penalty rate would be increased to 25 percent.

Rules are provided that would coordinate the interaction of this penalty with the understatement penalty and the fraud penalty.

Reportable transactions that are not listed transactions and do not have a significant purpose of tax avoidance would be subject to the general rules regarding substantial understatements.

The calculation of any penalty arising from a listed or reportable transaction with a tax avoidance purpose would be based on the amount of the understatement attributable to the transaction (without regard to other items on the tax return). Thus, the amount of the understatement would be determined as 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.

The proposal would clarify what constitutes "reasonable belief," and would provide that a reasonable belief will exist 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) 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. The proposal also sets forth certain criteria regarding the quality of the legal opinion being relied upon, as well as the

[99] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the disclosure provision.

independence of the advisor who is providing the legal opinion, in establishing whether a taxpayer had a reasonable belief that the tax treatment was more likely than not the correct treatment.

Effective Date

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

3. Modifications to the substantial understatement penalty

Present Law

Definition of substantial understatement

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).[100]

Reduction of understatement for certain positions

For purposes of a penalty that is attributable to a substantial understatement of tax, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[101]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[102]

Description of Proposal

Definition of substantial understatement

The proposal would modify the definition of "substantial" for corporate taxpayers. Under the proposal, a corporate taxpayer would have 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.

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[100] Sec. 6662(a) and -(d)(1)(A).

[101] Sec. 6662(d)(2)(B).

[102] Sec. 6662(d)(2)(D).

Reduction of understatement for certain positions

The proposal would elevate 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, the understatement would be reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also would authorize (but 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).

Effective Date

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

4. Tax shelter exception to confidentiality privileges relating to taxpayer communications

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

Description of Proposal

The proposal would modify 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 would not be subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

The proposal would be effective with respect to communications made on or after the date of enactment.

5. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[103] A "tax shelter" means any investment with respect to which the tax shelter ratio[104] 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 at least five investors).[105]

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.[106]

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,"[107] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[108] Certain exceptions are provided with respect to the second category of transactions.[109]

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 claims, knows, or has reason to know that a party

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[103] Sec. 6111(a).

[104] 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.

[105] Sec. 6111(c).

[106] Sec. 6111(d).

[107] Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

[108] Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

[109] Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[110]

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.[111] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposals

Disclosure of reportable transactions by material advisors

The proposal would repeal the present law rules with respect to registration of tax shelters. Instead, the proposal would require each material advisor with respect to any reportable transaction[112] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as prescribed by the Secretary.

The information return would 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.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to promoting, selling, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a

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[110] 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. 301.6111-2T(c)(1).

[111] Sec. 6707.

[112] A reportable transaction (which would include a listed transaction) has the same meaning as previously described in connection with the taxpayer-related provisions.

reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

Penalty for failing to furnish information regarding reportable transactions

The proposal would repeal the present law penalty for failure to register tax shelters. Instead, the proposal would impose a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction. The amount of the penalty would be $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 reportable transaction before the date the return that includes the transaction is filed. Intentional disregard of the requirement to register 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 could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the information penalty.

The terms "reportable transaction" and "listed transaction" would have the same meaning as previously described in connection with the taxpayer-related provisions.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions would apply to returns the due date for which is after the date of enactment.

6. Investor lists and applicable penalties

Present Law

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any 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).[113] Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).[114] A limited exception is provided for certain shelters if the total fees are less than $25,000 or if the expected reduction in tax liabilities for any single year is less than $1 million for corporations or $250,000 for non-corporate taxpayers.[115]

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[116]

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

Description of Proposals

Investor lists

Under the proposal, each material advisor[117] that is required to file an information return with respect to a reportable transaction[118] would be required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal would authorize the Secretary (but not require) to prescribe regulations which provide that, in cases in which 2 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 proposal would modify the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a person who is required to maintain an investor list and who

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[113] Sec. 6112.

[114] *See* Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

[115] *See* Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

[116] Sec. 6112(c)(2).

[117] The term "material advisor" has the same meaning as when used in connection with the requirement to file an information return under section 6111.

[118] The term "reportable transaction" has the same meaning as previously described in connection with the taxpayer-related provisions.

fails to make the list available upon request by the Secretary within 20 business days after the request would be subject to a $10,000 per day penalty. Thus, this penalty could apply when a person has failed to maintain a list, has maintained an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty could be waived if the failure to make the list available is due to reasonable cause.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists would apply to requests made after the date of enactment.

7. Actions to enjoin conduct with respect to tax shelters

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[119]

Description of Proposal

The proposal would expand this rule so that injunctions may also be sought with respect to the requirements of the reporting of tax shelters[120] and of the keeping of lists of investors by the organizers and sellers of potentially abusive tax shelters.[121]

Effective Date

The proposal would be effective on the day after the date of enactment.

8. Understatement of taxpayer's liability by income tax return preparer

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 a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that 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 that return is liable for a penalty of $1,000.

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[119] Code sec. 7408.

[120] Code sec. 6707, as amended by other provisions of this proposal.

[121] Code sec. 6708, as amended by other provisions of this proposal.

Description of Proposal

The proposal would alter the standards of conduct that must be met to avoid imposition of the first penalty. The proposal would replace the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment in the position was more likely than not the proper treatment. The proposal also would replace the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the proposal would increase the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment would be increased from $250 to $1,000. The penalty relating to willful or reckless conduct would be increased from $1,000 to $5,000.

Effective Date

The proposal would be effective for documents prepared after the date of enactment.

9. Penalty on failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[122] 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 with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[123] 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.[124]

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[122] 31 U.S.C. 5314.

[123] 31 U.S.C. 5321(a)(5).

[124] 31 U.S.C. 5322.

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[125] This report, which was statutorily required,[126] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal would add an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty would be $5,000. The penalty could be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal would be effective with respect to failures to report occurring on or after the date of enactment.

10. Frivolous tax returns and submissions

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[127] 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)).

Description of Proposal

The proposal would modify 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 proposal would also modify 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 would apply are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision would

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[125] *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.

[126] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

[127] 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.

permit the IRS to dismiss such requests. Second, the provision would permit 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 proposal would require the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

Effective Date

The proposal would be effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

11. Regulation of individuals practicing before the Department of the Treasury

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[128] 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.

Description of Proposal

The proposal would make two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal would expressly permit censure as a sanction. Second, the proposal would permit 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.

The proposal would also confirm the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose would be effective for actions taken after the date of enactment.

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[128] 31 U.S.C. 330.

12. Penalties on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[129] 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.

Description of Proposal

The proposal would modify 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 would apply 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 would not apply to a gross valuation overstatement.

Effective Date

The proposal would be effective for activities after the date of enactment.

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[129] Sec. 6700.

B. Tax Treatment of Inversion Transactions

Present Law

Background

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 is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[130] and the passive foreign investment company rules.[131] 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 earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

In contrast, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law.

Inversion transactions

Some U.S. corporations have reincorporated as foreign corporations in low-tax jurisdictions, thereby replacing the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions, commonly referred to as "inversions," place the corporate group in a position to derive two main U.S. tax benefits: (1) removing some or all of the group's foreign operations and income from the U.S. taxing jurisdiction; and (2) reducing the U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various "earnings stripping" strategies (e.g., making excessive payments of deductible interest or royalties to a new foreign parent). Inversion transactions may take many different forms, including stock inversions and asset inversions.

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, 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 post-inversion structure by reducing U.S.

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[130] Secs. 951-964.

[131] Secs. 1291-1298.

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, subject to certain limitations under present law. These limitations include section 163(j), which limits the deductibility of interest paid to related parties, if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income." More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an "arm's length" standard, and permit the Treasury Secretary to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions themselves may give rise to 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), 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 "toll charge" is reduced.

The transfer by the U.S. corporation 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). 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) 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 tax-free reorganization under the Code.

Description of Proposal

In general

The proposal would define two different types of corporate inversion transactions and would establish a different set of consequences for each type. Certain partnership transactions also would be covered.

Transactions involving at least 80 percent ownership

The first type of inversion would be 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; (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 50 percent or greater ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total business activities of the group. The proposal would deny 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.

In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity would be disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., "hook" stock), this 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, and the definition would not be met. Stock sold in a public offering related to the transaction at issue also would be 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 would be disregarded. In addition, the Treasury Secretary would be granted authority to issue regulations 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 would be granted authority to issue regulations treating certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

<u>Transactions involving greater than 50 percent but less than 80 percent ownership</u>

The second type of inversion covered by the proposal would be 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 would apply to the inversion. Under these rules, the inversion transaction would be respected (i.e., the foreign corporation would be treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure would be strengthened; (2) the IRS would be given expanded power to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to "earnings stripping" through related-party debt, would be strengthened. These measures generally would apply for a 10-year period following the inversion transaction.

Specifically, any applicable corporate-level "toll charge" imposed 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 would be taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits).

With respect to monitoring, the proposal would establish a new pre-filing procedure. Under this procedure, the taxpayer would be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 482, 845, 163(j), and 267(a)(3). The Treasury Secretary would be given the authority to specify the form,

content, and supporting information required for this application, as well as the timing for its submission.

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

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions would apply: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties would be permitted; (2) any transfers or licenses of intangible property to related foreign parties would be disregarded; and (3) any cost-sharing arrangements would not be respected for the taxable year for which the application was required.

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

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

Partnership transactions

Under the proposal, both types of inversion transactions are defined to include certain partnership transactions. Specifically, both prongs of the proposal would apply 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 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 definitions are met, all partnerships that are under common control within the meaning of section 482 would be treated as one partnership, except as provided otherwise in regulations. In addition, in situations in which the strengthened "toll charge" provisions would apply, those provisions would apply at the partner level.

Effective Date

The first prong of the proposal would apply to inversion transactions meeting the 80-percent test that are completed after March 20, 2002. The second prong of the proposal, limiting the benefits of other inversions, would apply to inversion transactions meeting the 50-percent test that are completed after 1996. The measures set forth in the second prong also would apply to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002, effective date of the first prong.

C. Reinsurance Agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[132] 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.[133] 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.

Description of Proposal

The proposal would modify the rules of section 845, relating to authority for the Treasury Secretary to allocate among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal would authorize 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[134] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties, including 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.

Effective Date

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

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[132] Sec. 845(a).

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

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

D. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[135] extended the statutory authorization for these user fees[136] through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees. The proposal would also move the statutory authorization for these fees into the Internal Revenue Code.

Effective Date

The provision, including moving the statutory authorization for these fees into the Code and repealing the off-Code statutory authorization for these fees, would be effective for requests made after the date of enactment.

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

[136] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

E. Imposition of Custom User Fees

Present Law

Section 13031(j)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(j)(3)) authorizes the temporary imposition and collection of custom user fees in connection with services provided by the United States Customs Service. The authorization is scheduled to expire on September 30, 2003.

Description of Proposal

The proposal would extend the authority to impose and collect custom user fees, provided, however, that any revenue generated from such custom user fees may be used only to fund the operations of the United States Customs Service.

Effective Date

The proposal would be effective on the date of enactment.

JOINT COMMITTEE ON TAXATION
June 11, 2002
JCX-58-02

ESTIMATED REVENUE EFFECTS OF THE "CARE ACT OF 2002," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
Charitable Giving Incentive Provisions														
1. Provide charitable contribution deduction for non-itemizers with cash contributions in excess of $250 for individuals and $500 for joint returns; cap on deduction of $250 for individuals and $500 for joint returns	tyba 12/31/01 & tybb 1/1/04	-185	-1,247	-1,131	---	---	---	---	---	---	---	---	-2,563	-2,563
2. Tax-free distributions from IRAs for charitable purposes - taxpayer must have attained age 70-1/2 for contributions made directly to a charitable organization and age 59.5 for contributions to a split-interest entity	tyba 12/31/02	---	-115	-250	-269	-272	-269	-268	-269	-281	-383	-505	-1,175	-2,880
3. Enhanced charitable deduction for contributions of food inventories	tyba 12/31/02	---	-79	-156	-175	-187	-195	-203	-212	-220	-228	-237	-792	-1,891
4. Enhanced charitable deduction for contributions of book inventories	tyba 12/31/02	---	-12	-19	-21	-23	-26	-28	-31	-34	-37	-41	-101	-273
5. Enhanced charitable deduction for contributions of appreciated bonds	tyba 12/31/02	---	-53	-97	-100	-104	-109	-113	-118	-123	-128	-133	-463	-1,077
6. Expand charitable contribution allowed for scientific property used for research and for computer technology and equipment	tyba 12/31/01	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
7. Encourage contributions of capital gain real property made for conservation purposes	tyba 12/31/02	---	-4	-6	-10	-14	-18	-26	-36	-46	-57	-69	-52	-285
8. 25% capital gain exclusion for sales of land or interest in land or water to eligible entities for conservation purposes	sma 12/31/03	---	-2	-18	-50	-76	-80	-85	-89	-94	-99	-105	-226	-698
9. Exclusion for government payments under Partners for Fish and Wildlife Program	tyba 12/31/02	---	-1	-2	-2	-3	-3	-3	-3	-3	-3	-3	-9	-23
10. Adjustment to basis of S corporation stock for certain charitable contributions	tyba 12/31/02	---	-12	-26	-30	-33	-36	-40	-45	-49	-55	-62	-137	-388
Total of Charitable Giving Incentive Provisions		**-186**	**-1,526**	**-1,706**	**-658**	**-713**	**-737**	**-767**	**-804**	**-851**	**-991**	**-1,156**	**-5,523**	**-10,089**
Disclosure of Information Relating to Tax-Exempt Organizations														
1. Disclosure of written determinations	dia 12/31/02	*Negligible Revenue Effect*												
2. Disclosure of name under which an organization does business and its Internet Web site	rfa 12/31/02	*Negligible Revenue Effect*												
3. Modification to reporting of capital transactions	rfa 12/31/02	*Negligible Revenue Effect*												
4. Disclosure that Form 990 is publicly available	fopiora DOE	*Negligible Revenue Effect*												

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
5. Disclosure to State officials of proposed actions related to certain section 501(c)(3) organizations	DOE	Negligible Revenue Effect												
Total of Disclosure of Information Relating to Tax-Exempt Organizations		**Negligible Revenue Effect**												
Other Charitable and Exempt Organization Provisions														
1. Modify tax on unrelated business taxable income of charitable remainder trusts	tyba 12/31/01	[1]	-4	-4	-4	-5	-5	-5	-5	-6	-6	-6	-22	-51
2. Modify section 512(b)(13) for tax exempt organizations and their subsidiaries with regard to certain specified payments	pra 12/31/00	-4	-25	-11	-11	-11	-12	-12	-13	-13	-13	-14	-74	-139
3. Simplification of lobbying expenditure limitation	tyba 12/31/01	[2]	-1	-1	-1	-1	-1	-1	-2	-2	-2	-2	-5	-15
4. Expedited review process for certain tax-exemption applications	ara 12/31/02	Negligible Revenue Effect												
5. Clarification of definition of church tax inquiry	DOE	No Revenue Effect												
6. Expansion of declaratory judgment procedures to non-501(c)(3) tax-exempt organizations	dma 12/31/01	Negligible Revenue Effect												
7. Definition of convention or association of churches	DOE	Negligible Revenue Effect												
8. Provide a charitable deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	cma 12/31/02	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-1	-3
9. Provide that certain payments by charitable organizations made by reason of the death, injury, wounding, or illness of military personnel incurred as a result of the war on terrorism are consistent with exempt purposes	pma DOE & pmb 9/11/03	Negligible Revenue Effect												
Total of Other Charitable and Exempt Organization Provisions		**-4**	**-30**	**-16**	**-16**	**-17**	**-18**	**-18**	**-20**	**-21**	**-21**	**-22**	**-102**	**-208**
Restoration of Social Services Block Grant Funding (outlays) [3]	[4]	**---**	**-345**	**-908**	**-323**	**52**	**49**	**59**	**41**	**---**	**---**	**---**	**-1,475**	**-1,375**
Revenue Raising Provisions														
1. The "Tax Shelter Transparency Act":														
a. Provisions relating to reportable transactions and tax shelters (sections 101, 102, 104, 201 through 203, and 215) [5]	various dates after DOE [6]	17	56	99	123	126	125	129	134	141	150	162	547	1,262
b. Modification to the substantial understatement penalty (section 103) [5]	tyba DOE	---	---	---	8	11	19	23	26	30	34	38	38	188
c. Actions to enjoin conduct with respect to tax shelters (section 204)	DOE	Negligible Revenue Effect												
d. Understatement of taxpayer's liability by income tax return preparer (section 211)	dpa DOE	Negligible Revenue Effect												
e. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 212)	DOE	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	1	3
f. Frivolous tax submissions (section 213)	[8]	---	3	3	3	3	3	3	3	3	3	3	15	30
g. Regulation of individuals practicing before the Department of Treasury (section 214)	ata DOE	No Revenue Effect												
Total of the "Tax Shelter Transparency Act"	---	17	59	102	134	140	147	155	163	174	187	203	601	1,483

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
2. Tax treatment of inversion transactions; reinsurance agreements	[9]	25	81	97	117	140	168	202	242	290	348	418	628	2,128
3. Extend IRS user fees through 12/31/09 [3]	DOE	---	---	33	34	35	36	38	39	14	---	---	138	229
4. Extend customs user fees through 12/31/08:														
a. Merchandise processing fee [3]	DOE	---	---	1,026	1,078	1,132	1,188	1,248	328	---	---	---	4,424	6,000
b. COBRA fee [3]	DOE	---	---	248	347	365	383	402	105	---	---	---	1,343	1,850
Total of Revenue Raising Provisions		**42**	**140**	**1,506**	**1,710**	**1,812**	**1,922**	**2,045**	**877**	**478**	**535**	**621**	**7,134**	**11,690**
NET TOTAL		**-148**	**-1,761**	**-1,124**	**713**	**1,134**	**1,216**	**1,319**	**94**	**-394**	**-477**	**-557**	**34**	**18**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

ara = applications received after
ata = actions taken after
cma = contributions made after
dia = determinations issued after
dma = determinations made after
DOE = date of enactment
dpa = documents prepared after
fopiora = forms or publications issued or revised after
pma = payments made after
pmb = payments made before
pra = payments received after
rfa = returns filed after
sma = sales made after
tyba = taxable years beginning after
tybb = taxable years beginning before

[1] Loss of less than $1 million.
[2] Loss of less than $500,000.
[3] Estimate provided by the Congressional Budget Office.
[4] Effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports would be with respect to fiscal year 2002 and each fiscal year thereafter.
[5] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.
[6] Effective dates for provisions relating to reportable transactions and tax shelters: section 101 is effective for returns and statements the due date of which is after the date of enactment; section 102 is effective for taxable years ending after the date of enactment; section 104 is effective for communications made on or after the date of enactment; section 201 is effective for transactions with respect to which material aid, assistance or advice is provided after the section 202 is effective for returns the due date for which is after the date of enactment; section 203 is effective for requests made after the date of enactment; and section 215 is effective for activities after the date of enactment.
[7] Gain of less than $1 million.
[8] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[9] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002, and certain insurance risks reinsured after April 11, 2002.

Joint Committee on Taxation
June 12, 2002
JCX-61-02

DESCRIPTION OF CHAIRMAN'S MODIFICATIONS TO THE PROVISIONS OF THE "CARE ACT OF 2002" SCHEDULED FOR A MARKUP BY THE SENATE COMMITTEE ON FINANCE ON JUNE 13, 2002[1]

A. Modifications to the CARE Act of 2002

The following modifications would be made to the provisions of the CARE Act of 2002.[2]

1. Charitable deduction for contributions of food inventory

The Chairman's modification would delete the proposal to increase the amount of the deduction for eligible contributions of food inventory. Therefore, the Chairman's modification would retain the present-law rule relating to the amount of the enhanced deduction for eligible contributions of food inventory.

2. Charitable deduction for contributions of book inventory

The Chairman's modification would provide that the fair market value of a book is any bona fide published market price for the book (using the same printing and same edition), published within seven years preceding the contribution.

3. Charitable deduction for contributions of bonds

The Chairman's modification would eliminate the provision relating to charitable deduction for contributions of bonds.

4. Tax treatment of inversion transactions

The Chairman's modification would provide that, in cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Modifications to the Provisions of the "CARE Act of 2002" Scheduled for a Markup By the Senate Committee on Finance on June 13, 2002* (JCX-61-02), June 12, 2002.

[2] A description of the provisions of the "CARE Act of 2002" is contained in Joint Committee on Taxation, *Description of the "CARE Act of 2002"* (JCX-57-02), June 11, 2002.

provisions of the "Reversing the Expatriation of Profits Offshore Act" generally would 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 would be given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

The Chairman's modification would require inverting entities to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

5. Extension of IRS user fees

The Chairman's modification would adjust the period of extension of the IRS user fees so as to make the bill revenue neutral.

6. Extension of Custom user fees

The Chairman's modification would adjust the period of extension of the authority to impose and collect customs user fees for a sufficient period of time so as to make the bill revenue neutral.

B. New Provisions

The Chairman's modification would add the following provisions to the CARE Act of 2002:

1. Enhanced deduction for charitable contribution of literary, musical, artistic, and scholarly compositions

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction generally is limited to the taxpayer's basis in the property.[3] In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions of tangible personal property to a private foundation (other than certain private foundations),[4] the amount of the deduction is limited to the taxpayer's basis in the property.

Under present law, charitable contributions of literary, musical, and artistic compositions are considered ordinary income property and a taxpayer's deduction of such property is limited to the taxpayer's basis (typically, cost) in the property. To be eligible for the deduction, the contribution must be of an undivided portion of the donor's entire interest in the property.[5] For

[3] Sec. 170(e)(1).

[4] Sec. 170(e)(1)(B)(ii).

[5] Sec. 170(f)(3).

purposes of the charitable income tax deduction, the copyright and the work in which the copyright is embodied are not treated as separate property interests. Accordingly, if a donor owns a work of art and the copyright to the work of art, a gift of the artwork without the copyright or the copyright without the artwork will constitute a gift of a "partial interest" and will not qualify for the income tax charitable deduction.

Description of Proposal

The proposal would provide that a deduction for qualified artistic charitable contributions generally would be increased from the value under present law (generally, basis) to the fair market value of the property contributed, measured at the time of the contribution. However, the amount of the increase of the deduction provided by the proposal could not exceed the amount of the donor's adjusted gross income for the taxable year attributable to: (1) income from the sale or use of property created by the donor that is of the same type as the donated property; and (2) income from teaching, lecturing, performing, or similar activities with respect to such property. In addition, the increase to the present-law deduction provided by the proposal could not be carried over and deducted in other taxable years.

The proposal would define a qualified artistic charitable contribution to mean a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both). The tangible property and the copyright on such property would be treated as separate interests in the property for purposes of the "partial interest" rule; thus, a gift of artwork without the copyright or a copyright without the artwork would not constitute a gift of a partial interest and would be deductible. Contributions of letters, memoranda, or similar property that are written, prepared, or produced by or for an individual in his or her capacity as an officer or employee of any person (including a government agency or instrumentality) would not qualify for a fair market value deduction unless the contributed property was entirely personal.

In addition, a contribution would have to meet several requirements in order to qualify for the fair market value deduction. First, the contributed property would have to have been created by the personal efforts of the donor at least 18 months prior to the date of contribution. Second, the donor would have to obtain a qualified appraisal of the contributed property, a copy of which would be required to be attached to the donor's income tax return for the taxable year in which such contribution is made. Third, the contribution would have to be made to a public charity or to certain limited types of private foundations. Finally, the use of donated property by the recipient organization would have to be related to the organization's charitable purpose or function, and the donor must receive a written statement from the organization verifying such use.

Effective Date

The deduction for qualified artistic charitable contributions applies to contributions made after December 31, 2002.

2. Modify rules governing tax-exempt bonds for section 501(c)(3) organizations as applied to organizations engaged in timber conservation activities

Present Law

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in Code section 501(c)(3) ("qualified 501(c)(3) bonds").

Qualified 501(c)(3) bonds may be issued only to finance the activities that qualify the organization for tax-exemption, as opposed to unrelated business activities of these organizations. If the bonds are issued to finance property which is intended to be sold to a private business while the bonds are outstanding, bond interest may not qualify for tax-exemption. Similarly, if the property is in fact sold, bond interest may become retroactively taxable unless remedial actions specified in Treasury Department regulations are taken. An example of such a situation would be bonds that are issued as qualified 501(c)(3) bonds issued to finance the purchase of land and standing timber when the timber was to be sold.

As is true of governmental activities receiving tax-exempt financing, section 501(c)(3) organizations are restricted in the arrangements they may have with private businesses relating to control and use of bond-financed property.

Description of Proposal

The proposal would modify the rules governing issuance of qualified 501(c)(3) bonds to permit the issuance of long-term bonds for the acquisition of land and timber associated with such land subject to a conservation restriction. Under the proposal, the bonds would not fail to be qualified 501(c)(3) bonds if the timber was sold, leased, or otherwise used by an unaffiliated person to the extent that such sale, leasing, or other use did not constitute an unrelated trade or business, and so long as the other requirements of the proposal were met. In addition, these bonds may not constitute qualified 501(c)(3) bonds unless the seller of the land and timber property that is to be acquired with the bond proceeds irrevocably elects not to exclude from income any portion of the gain on the sale of such property made for qualifying conservation purposes.

Under the proposal, section 501(c)(3) organizations could enter into certain otherwise prohibited timber management arrangements with private businesses without losing tax-exemption on bonds used to finance the property and timber. Similarly, the bonds could be issued on a tax-exempt basis notwithstanding plans by the section 501(c)(3) organization to harvest and sell standing timber on land being acquired.

The aggregate amount of bonds that could be issued pursuant to this proposal would be subject to a national limitation of $2 billion. This volume limitation, for the period October 1, 2002, to December 31, 2005, would be allocated by the Department of Treasury to qualified

section 501(c)(3) organizations based on criteria established by the Treasury (after consultation with appropriate Federal, State, and local officials).

Effective Date

The proposal would be effective for bonds issued after September 30, 2002, and before January 1, 2006.

3. Modification with respect to Rite Aid case

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.[6]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[7]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[8]

In the recent case of *Rite Aid Corp. v. United States,*[9] 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. The particular provision,

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[6] Section 1501.

[7] Section 1502.

[8] 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. 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).

[9] 255 F.3d 1357 (Fed. Cir. 2001).

known as the "duplicated loss" provision,[10] 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.

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.[11]

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 not to apply that provision.[12]

There is a concern that some taxpayers might attempt to take a position that under the language and reasoning of the Federal Circuit Court decision in the *Rite Aid* case, other consolidated return regulations not involved in that case (*i.e.*, to the extent they provide a different result than if corporations had filed separate returns) might now be considered subject to challenge. This might create uncertainty or lead to protracted litigation.

Description of Proposal

The proposal would provide that the regulatory authority provided in section 1502 shall be construed without regard to the interpretation of that authority in the decision of the Federal Circuit Court in *Rite Aid Corp. v. United States.*[13] That is, the proposal would overrule the

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[10] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[11] For example, the court stated: "The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[12] The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also*, Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).

[13] 255 F.3d 1357 (2001).

court's reasoning that there was not a problem resulting from the filing of consolidated returns because a corporate taxpayer could deduct a loss on the sale of stock of a nonconsolidated subsidiary. The proposal would thus deny the case any precedential effect with respect to other consolidated return regulations.

The proposal would nevertheless allow the result of the case to stand, with respect to the specific regulatory provision that was invalidated in the case (Treas. Reg. Sec. 1.1502-20(c)(1)(iii)).

The proposal would confirm that consolidated return regulations may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

The proposal would thus confirm that Treasury is authorized to issue consolidated return regulations utilizing either a single entity or separate entity 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.

Effective Date

The proposal would be effective for all taxable years, whether beginning before, with, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

4. Provide tax exemption for organizations created by a State to provide property and casualty insurance coverage for property for which such coverage is otherwise unavailable

Present Law

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term "corporation" includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax-exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

Health coverage for high-risk individuals

Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal would provide tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for wind storm, hail and fire damage to property located within the State for which the State has determined that coverage in the authorized insurance market is limited or unavailable at reasonable rates, provided certain requirements are met.

Under the proposal, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association; or (4) to make remittances pursuant to State law to be used by the State to provide for the payment of claims on policies written by the association, purchase reinsurance covering losses under such policies, or to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. Under the proposal, it would be required that the State law governing the association permit the association to levy assessments on insurance companies authorized to sell property and casualty insurance in the State, or on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. Under the proposal, it would be required that the plan of operation of the association be subject to approval by the chief executive officer or other official

of the State, by the State legislature, or both. In addition, it would be required that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The proposal would provide a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the proposal, to make disbursements to pay claims on insurance contracts issued by the association, and to make disbursements to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The special rule would provide that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the proposal, from which it receives such remittances. The election would be required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the proposal, and would be effective as of the effective date of that determination.

An organization described in the proposal would be treated as having unrelated business taxable income ("UBIT") in the amount of its taxable income (computed as if the organization were not exempt from tax under the proposal), if at the end of the immediately preceding taxable year, the organization's net equity exceeded 15 percent of the total coverage in force under insurance contracts issued by the organization and outstanding at the end of that preceding year.

Under the proposal, no income or gain would be recognized solely as a result of the change in status to that of an association exempt from tax under the proposal.

Effective Date

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

5. Conform provisions relating to arbitrage treatment of certain university fund to State constitutional amendments

Present Law

In general, present-law tax-exempt arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception, enacted in 1984, provides that the pledge of income from investments in a Fund established under a provision of a State constitution adopted in 1876 as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions in effect as of October 9, 1969.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The State constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. The constitution does not permit the expenditure or

mortgage of the Fund for any purpose. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the two university systems are secured by and payable from the income of the Fund. These bonds are used to finance buildings and other permanent improvements for the universities.

The State constitutional rules governing the Fund have been modified with regard to the manner in which amounts in the Fund are paid for the benefit of the two university systems.

Description of Proposal

The 1984 exception would be conformed to the present State constitutional provisions governing the Fund's ability to make annual distributions in a manner similar to standard university endowment funds. Limitations on the aggregate amount of bonds that may benefit from the exception would not be modified.

Effective Date

The proposal would be effective on the date of enactment.

6. Matching grants to low-income taxpayer clinics for return preparation

Present Law

The Code[14] provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain low-income taxpayer clinics that represent low-income taxpayers in controversies with the IRS or that operate programs to inform individuals for whom English is a second language about their tax-related rights and responsibilities.

Description of Proposal

The proposal would authorize the Secretary to create a separate grant program to provide up to $10 million per year in matching grants to not for profit organizations that assist low-income taxpayers in the preparation of their Federal tax returns.

Effective Date

The proposal would be effective on the date of enactment.

[14] Sec. 7526.

JOINT COMMITTEE ON TAXATION
June 13, 2002
JCX-64-02

ESTIMATED REVENUE EFFECTS OF THE "CARE ACT OF 2002," AS MODIFIED BY THE CHAIRMAN'S MODIFICATION, SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
Charitable and Tax Exempt Organization Provisions, and SSBG Funding														
Charitable Giving Incentive Provisions														
1. Provide charitable contribution deduction for non-itemizers with cash contributions in excess of $250 for individuals and $500 for joint returns; cap on deduction of $250 for individuals and $500 for joint returns	tyba 12/31/01 & tybb 1/1/04	-185	-1,247	-1,131	---	---	---	---	---	---	---	---	-2,563	-2,563
2. Tax-free distributions from IRAs for charitable purposes - taxpayer must have attained age 70-1/2 for contributions made directly to a charitable organization and age 59.5 for contributions to a split-interest entity	tyba 12/31/02	---	-115	-250	-269	-272	-269	-268	-269	-281	-383	-505	-1,175	-2,880
3. Extend present-law section 170(e)(3) deduction for food inventory to al businesses	tyba 12/31/02	---	-29	-55	-61	-66	-69	-71	-74	-77	-80	-83	-280	-665
4. Enhanced charitable deduction for contributions of book inventories, with special basis rule	tyba 12/31/02	---	-16	-26	-29	-32	-36	-40	-44	-48	-52	-56	-139	-379
5. Expand charitable contribution allowed for scientific property used for research and for computer technology and equipment	tyba 12/31/01	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
6. Encourage contributions of capital gain real property made for conservation purposes	tyba 12/31/02	---	-4	-6	-10	-14	-18	-26	-36	-46	-57	-69	-52	-285
7. 25% capital gain exclusion for sales of land or interest in land or water to eligible entities for conservation purposes	sma 12/31/03	---	-2	-18	-50	-76	-80	-85	-89	-94	-99	-105	-226	-698
8. Exclusion for government payments under Partners for Fish and Wildlife Program	tyba 12/31/02	---	-1	-2	-2	-3	-3	-3	-3	-3	-3	-3	-9	-23
9. Adjustment to basis of S corporation stock for certain charitable contributions	tyba 12/31/02	---	-12	-26	-30	-33	-36	-40	-45	-49	-55	-62	-137	-388
10. Enhanced deduction for charitable contribution of literary, musical, artistic, and scholarly compositions	cma 12/31/02	---	-2	-4	-4	-5	-5	-6	-6	-6	-7	-7	-20	-52
Total of Charitable Giving Incentive Provisions		-186	-1,429	-1,519	-456	-502	-517	-540	-567	-605	-737	-891	-4,606	-7,944
Disclosure of Information Relating to Tax-Exempt Organizations														
1. Disclosure of written determinations	dia 12/31/02	*Negligible Revenue Effect*												

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
2. Disclosure of name under which an organization does business and its Internet Web site	rfa 12/31/02	Negligible Revenue Effect												
3. Modification to reporting of capital transactions	rfa 12/31/02	Negligible Revenue Effect												
4. Disclosure that Form 990 is publicly available	fopiora DOE	Negligible Revenue Effect												
5. Disclosure to State officials of proposed actions related to certain section 501(c)(3) organizations	DOE	Negligible Revenue Effect												
Total of Disclosure of Information Relating to Tax-Exempt Organizations		**Negligible Revenue Effect**												
Other Charitable and Exempt Organization Provisions														
1. Modify tax on unrelated business taxable income of charitable remainder trusts	tyba 12/31/01	[1]	-4	-4	-4	-5	-5	-5	-5	-6	-6	-6	-22	-51
2. Modify section 512(b)(13) for tax exempt organizations and their subsidiaries with regard to certain specified payments	pra 12/31/00	-4	-25	-11	-11	-11	-12	-12	-13	-13	-13	-14	-74	-139
3. Simplification of lobbying expenditure limitation	tyba 12/31/01	[2]	-1	-1	-1	-1	-1	-1	-2	-2	-2	-2	-5	-15
4. Expedited review process for certain tax-exemption applications	ara 12/31/02	Negligible Revenue Effect												
5. Clarification of definition of church tax inquiry	DOE	No Revenue Effect												
6. Expansion of declaratory judgment procedures to non-501(c)(3) tax-exempt organizations	dma 12/31/01	Negligible Revenue Effect												
7. Definition of convention or association of churches	DOE	Negligible Revenue Effect												
8. Provide a charitable deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	cma 12/31/02	—	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-1	-3
9. Provide that certain payments by charitable organizations made by reason of the death, injury, wounding, or illness of military personnel incurred as a result of the war on terrorism are consistent with exempt purposes	pma DOE & pmb 9/11/03	Negligible Revenue Effect												
10. Provide tax exemption for organizations created by a State to provide property and casualty insurance coverage for property for which such coverage is otherwise unavailable	tyba 12/31/01	-2	-4	-4	-5	-6	-6	-7	-8	-8	-9	-9	-27	-68
11. Conform provisions relating to arbitrage treatment of certain university fund to State constitutional amendments	DOE	—	-1	[2]	[3]	[2]	-1	[2]	[2]	[2]	[2]	[2]	-3	-4
12. Modify rules governing tax-exempt bonds for section 501(c)(3) organizations as applied to organizations engaged in timber conservation activities (cap at $2.0 billion)	bia 9/30/02 & bib 1/1/06	—	-7	-20	-30	-32	-31	-29	-27	-27	-27	-27	-120	-255
13. Authorization for Appropriation - Low-Income Taxpayer Clinics [4]	DOE	No Revenue Effect												
Total of Other Charitable and Exempt Organization Provisions		-6	-42	-40	-51	-55	-56	-54	-55	-56	-57	-58	-252	-535
Restoration of Social Services Block Grant Funding (outlays) [4]	[5]	—	-345	-908	-323	52	49	59	41	—	—	—	-1,475	-1,375
Total of Charitable and Tax Exempt Organization Provisions, and SSBG Funding		-192	-1,816	-2,467	-830	-505	-524	-535	-581	-661	-794	-949	-6,333	-9,854

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
Revenue Raising Provisions														
1. The "Tax Shelter Transparency Act":														
a. Provisions relating to reportable transactions and tax shelters (sections 101, 102, 104, 201 through 203, and 215) [6]	various dates after DOE [7]	17	56	99	123	126	125	129	134	141	150	162	547	1,262
b. Modification to the substantial understatement penalty (section 103) [6]	tyba DOE	---	---	---	8	11	19	23	26	30	34	38	38	188
c. Actions to enjoin conduct with respect to tax shelters (section 204)	DOE	Negligible Revenue Effect												
d. Understatement of taxpayer's liability by income tax return preparer (section 211)	dpa DOE	Negligible Revenue Effect												
e. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 212)	DOE	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	1	3
f. Frivolous tax submissions (section 213)	[9]	---	3	3	3	3	3	3	3	3	3	3	15	30
g. Regulation of individuals practicing before the Department of Treasury (section 214)	ata DOE	No Revenue Effect												
Total of the "Tax Shelter Transparency Act"	---	17	59	102	134	140	147	155	163	174	187	203	601	1,483
2. Tax treatment of inversion transactions; reinsurance agreements; require inverting entities to provide information to shareholders/partners and the IRS with respect to the tax treatment of the inversion	[10]	25	81	97	117	140	168	202	242	290	348	418	628	2,128
3. Extend IRS user fees through 12/31/07 [4]	DOE	---	---	33	34	35	36	9	---	---	---	---	138	147
4. Extend customs user fees through 12/31/07:														
a. Merchandise processing fee [4]	DOE	---	---	1,026	1,078	1,132	1,188	312	---	---	---	---	4,424	4,736
b. COBRA fee [4]	DOE	---	---	248	347	365	383	101	---	---	---	---	1,343	1,444
5. Modification with respect to Rite Aid case	[11]	Negligible Revenue Effect												
Total of Revenue Raising Provisions		42	140	1,506	1,710	1,812	1,922	779	405	464	535	621	7,134	9,938
NET TOTAL		-150	-1,676	-961	880	1,307	1,398	244	-176	-197	-259	-328	801	84

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

ara = applications received after
ata = actions taken after
bia = bonds issued after
bib = bonds issued before
cma = contributions made after
dia = determinations issued after
dma = determinations made after
DOE = date of enactment
dpa = documents prepared after
fopiora = forms or publications issued or revised after
pma = payments made after
pmb = payments made before
pra = payments received after
rfa = returns filed after
sma = sales made after
tyba = taxable years beginning after
tybb = taxable years beginning before

[1] Loss of less than $1 million.
[2] Loss of less than $500,000.
[3] Gain of less than $500,000.
[4] Estimate provided by the Congressional Budget Office.
[5] Effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports would be with respect to fiscal year 2002 and each fiscal year thereafter.

[Footnotes for JCX-64-02 are continued on the following page]

Footnotes for JCX-64-02 continued:

[6] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.

[7] Effective dates for provisions relating to reportable transactions and tax shelters: section 101 is effective for returns and statements the due date of which is after the date of enactment; section 102 is effective for taxable years ending after the date of enactment; section 104 is effective for communications made on or after the date of enactment; section 201 is effective for transactions with respect to which material aid, assistance or advice is provided after the section 202 is effective for returns the due date for which is after the date of enactment; section 203 is effective for requests made after the date of enactment; and section 215 is effective for activities after the date of enactment.

[8] Gain of less than $1 million.

[9] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).

[10] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002, and certain insurance risks reinsured after April 11, 2002.

[11] Effective for all taxable years, whether beginning before, with, or after the date of enactment.

DESCRIPTION OF PROPOSALS IN S. 2498, THE "TAX SHELTER TRANSPARENCY ACT"

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

June 11, 2002
JCX-53-02

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of S. 2498, the "Tax Shelter Transparency Act." This document[1], prepared by the staff of the Joint Committee on Taxation, provides a description of S. 2498, the "Tax Shelter Transparency Act".

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of S. 2498, the "Tax Shelter Transparency Act,"* (JCX-53-02), June 11, 2002.

I. PROPOSALS RELATING TO THE TAX SHELTER TRANSPARENCY ACT

A. Penalty for Failure to Disclose Reportable Transactions (sec. 101 of the bill and new sec. 6707A of the Code)

Present Law

Regulations under section 6011 require corporate taxpayers to disclose with their tax return certain information with respect to each "reportable transaction" in which the corporate taxpayer participates.[2]

There are two categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A corporation must disclose any listed transaction that is expected to reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or more than $2 million in any combination of years.[3]

The second category of reportable transactions is transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of $5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.[4]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer's ability to claim that any

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[2] Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4.

[3] Temp. Treas. Reg. sec. 1.6011-4T(b)(2) and -(b)(4)(i).

[4] Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[5]

Description of Proposal

The proposal would create 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 would apply without regard to whether the transaction ultimately results in an understatement of tax and is in addition to any accuracy-related penalty that may be imposed.

The penalty for failing to disclose a reportable transaction 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 could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the disclosure penalties.

A public entity that is subject to a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose[6]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") (for such period as the Secretary shall specify). The proposal would treat any failure to disclose a transaction in reports to the SEC as a failure to disclose a listed transaction.

The proposal would define a "listed transaction" and a "reportable transaction" by reference to the definition given to these terms in Treasury regulations under section 6011. A "large entity" would be 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" would be 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.

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[5] 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.

[6] This category of transactions is described in greater detail below in connection with the proposal to modify the accuracy-related penalty to tax shelters.

Effective Date

The proposal would be effective for returns and statements the due date for which is after the date of enactment.

B. Modifications to the Accuracy-Related Penalties for Listed Transactions and Reportable Transactions Having a Significant Tax Avoidance Purpose (sec. 102 of the bill and secs. 6662 and 6664 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.[7] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[8]

Special rules apply with respect to tax shelters.[9] 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.[10] 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.[11]

Description of Proposal

The proposal would modify the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new set of rules that would apply to listed transactions and

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[7] Sec. 6662.

[8] Sec. 6662(d)(2)(B).

[9] Sec. 6662(d)(2)(C).

[10] Sec. 6664(c).

[11] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

reportable transactions with a significant tax avoidance purpose.[12] The rate of the penalty and the defenses that would be available to avoid the penalty would vary depending on the type of transaction and on whether the transaction was adequately disclosed.

Under the proposal, a 20-percent penalty would apply to any understatement attributable to a listed transaction or a reportable transaction with a significant purpose of tax avoidance. The only exception to the penalty would be the reasonable cause and good faith exception of section 6664(c). Under the proposal, the reasonable cause exception would apply only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed treatment, and the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment.

If the taxpayer does not adequately disclose the transaction, the reasonable cause and good faith exception would not be available, and a higher penalty rate would apply. If the understatement is attributable to an undisclosed listed transaction, the penalty rate would be increased to 30 percent. For understatements attributable to an undisclosed reportable transaction with a significant tax avoidance purpose, the penalty rate would be increased to 25 percent. Rules are provided that would coordinate the interaction of this penalty with the understatement penalty and the fraud penalty.

Reportable transactions that are not listed transactions and do not have a significant purpose of tax avoidance would be subject to the general rules regarding substantial understatements.

The calculation of any penalty arising from a listed or reportable transaction with a tax avoidance purpose would be based on the amount of the understatement attributable to the transaction (without regard to other items on the tax return). Thus, the amount of the understatement would be determined as 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.[13]

The proposal would clarify what constitutes "reasonable belief," and would provide that a reasonable belief will exist 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) 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. The proposal also sets forth certain criteria regarding the quality of the legal opinion being relied upon, as well as the independence of the advisor who is providing the legal opinion, in establishing whether a

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[12] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the disclosure provision.

[13] For this purpose, any reduction in a loss would be treated as an increase in taxable income.

taxpayer had a reasonable belief that the tax treatment was more likely than not the correct treatment.

Effective Date

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

C. Modifications to the Substantial Understatement Penalty (sec. 103 of the bill and sec. 6662 of the Code)

Present Law

Definition of substantial understatement

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).[14]

Reduction of understatement for certain positions

For purposes of a penalty that is attributable to a substantial understatement of tax, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[15]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[16]

Description of Proposal

Definition of substantial understatement

The proposal would modify the definition of "substantial" for corporate taxpayers. Under the proposal, a corporate taxpayer would have 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.

Reduction of understatement for certain positions

The proposal would elevate 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, the understatement would be reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also would authorize (but not require) the Secretary to publish a list of

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[14] Sec. 6662(a) and -(d)(1)(A).

[15] Sec. 6662(d)(2)(B).

[16] Sec. 6662(d)(2)(D).

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).

Effective Date

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

D. Tax Shelter Exception to Confidentiality Privileges Relating to Taxpayer Communications (sec. 104 of the bill 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.

Description of Proposal

The proposal would modify 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 would not be subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

The proposal would be effective with respect to communications made on or after the date of enactment.

E. Disclosure of Reportable Transactions by Material Advisors (secs. 201 and 202 of the bill 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.[17] A "tax shelter" means any investment with respect to which the tax shelter ratio[18] 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 at least five investors).[19]

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.[20]

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,"[21] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[22] Certain exceptions are provided with respect to the second category of transactions.[23]

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 claims, knows, or has reason to know that a party

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[17] Sec. 6111(a).

[18] 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.

[19] Sec. 6111(c).

[20] Sec. 6111(d).

[21] Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

[22] Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

[23] Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[24]

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.[25] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposals

Disclosure of reportable transactions by material advisors

The proposal would repeal the present law rules with respect to registration of tax shelters. Instead, the proposal would require each material advisor with respect to any reportable transaction[26] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as prescribed by the Secretary.

The information return would 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.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to promoting, selling, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a

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[24] 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. 301.6111-2T(c)(1).

[25] Sec. 6707.

[26] A reportable transaction (which would include a listed transaction) has the same meaning as previously described in connection with the taxpayer-related provisions.

reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

Penalty for failing to furnish information regarding reportable transactions

The proposal would repeal the present law penalty for failure to register tax shelters. Instead, the proposal would impose a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction. The amount of the penalty would be $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 reportable transaction before the date the return that includes the transaction is filed. Intentional disregard of the requirement to register 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 could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the information penalty.

The terms "reportable transaction" and "listed transaction" would have the same meaning as previously described in connection with the taxpayer-related provisions.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions would apply to returns the due date for which is after the date of enactment.

F. Investor Lists and Applicable Penalties (secs. 201 and 203 of the bill and secs. 6112 and 6708 of the Code)

Present Law

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any 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).[27] Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).[28] A limited exception is provided for certain shelters if the total fees are less than $25,000 or if the expected reduction in tax liabilities for any single year is less than $1 million for corporations or $250,000 for non-corporate taxpayers.[29]

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[30]

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

Description of Proposals

Investor lists

Under the proposal, each material advisor[31] that is required to file an information return with respect to a reportable transaction[32] would be required to maintain a list that (1) identifies

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[27] Sec. 6112.

[28] *See* Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

[29] *See* Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

[30] Sec. 6112(c)(2).

[31] The term "material advisor" has the same meaning as when used in connection with the requirement to file an information return under section 6111.

[32] The term "reportable transaction" has the same meaning as previously described in connection with the taxpayer-related provisions.

each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal would authorize the Secretary (but not require) to prescribe regulations which provide that, in cases in which 2 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 proposal would modify the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a person who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request would be subject to a $10,000 per day penalty. Thus, this penalty could apply when a person has failed to maintain a list, has maintained an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty could be waived if the failure to make the list available is due to reasonable cause.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists would apply to requests made after the date of enactment.

G. Actions to Enjoin Conduct with Respect to Tax Shelters (sec. 204 of the bill 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.[33]

Description of Proposal

The proposal would expand this rule so that injunctions may also be sought with respect to the requirements of the reporting of tax shelters[34] and of the keeping of lists of investors by the organizers and sellers of potentially abusive tax shelters.[35]

Effective Date

The proposal would be effective on the day after the date of enactment.

[33] Code sec. 7408.

[34] Code sec. 6707, as amended by other provisions of this proposal.

[35] Code sec. 6708, as amended by other provisions of this proposal.

H. Understatement of Taxpayer's Liability by Income Tax Return Preparer (sec. 211 of the bill and sec. 6694 of the Code)

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 a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that 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 that return is liable for a penalty of $1,000.

Description of Proposal

The proposal would alter the standards of conduct that must be met to avoid imposition of the first penalty. The proposal would replace the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment in the position was more likely than not the proper treatment. The proposal also would replace the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the proposal would increase the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment would be increased from $250 to $1,000. The penalty relating to willful or reckless conduct would be increased from $1,000 to $5,000.

Effective Date

The proposal would be effective for documents prepared after the date of enactment.

I. Penalty on Failure to Report Interests in Foreign Financial Accounts (sec. 212 of the bill)

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[36] 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 with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[37] 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.[38]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[39] This report, which was statutorily required,[40] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal would add an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty

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[36] 31 U.S.C. 5314.

[37] 31 U.S.C. 5321(a)(5).

[38] 31 U.S.C. 5322.

[39] *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.

[40] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

would be $5,000. The penalty could be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal would be effective with respect to failures to report occurring on or after the date of enactment.

J. Frivolous Tax Returns and Submissions (sec. 213 of the bill 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[41] 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)).

Description of Proposal

The proposal would modify 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 proposal would also modify 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 would apply are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision would permit the IRS to dismiss such requests. Second, the provision would permit 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 proposal would require the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

Effective Date

The proposal would be effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

[41] 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.

K. Regulation of Individuals Practicing Before the Department of the Treasury (sec. 214 of the bill and sec. 330 of Title 31, United States Code)

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[42] 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.

Description of Proposal

The proposal would make two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal would expressly permit censure as a sanction. Second, the proposal would permit 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.

The proposal would also confirm the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose would be effective for actions taken after the date of enactment.

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[42] 31 U.S.C. 330.

L. Penalties on Promoters of Tax Shelters (sec. 215 of the bill 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.[43] 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.

Description of Proposal

The proposal would modify 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 would apply 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 would not apply to a gross valuation overstatement.

Effective Date

The proposal would be effective for activities after the date of enactment.

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[43] Sec. 6700.

JOINT COMMITTEE ON TAXATION
June 11, 2002
JCX-54-02

**ESTIMATED REVENUE EFFECTS OF S. 2498,
THE "TAX SHELTER TRANSPARENCY ACT,"
SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002**

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
1. Provisions relating to reportable transactions and tax shelters (sections 101, 102, 104, 201 through 203, and 215) [1]	various dates after DOE [2]	17	56	99	123	126	125	129	134	141	150	162	547	1,262
2. Modification to the substantial understatement penalty (section 103) [1]	tyba DOE	---	---	---	8	11	19	23	26	30	34	38	38	188
3. Actions to enjoin conduct with respect to tax shelters (section 204)	DOE	*Negligible Revenue Effect*												
4. Understatement of taxpayer's liability by income tax return preparer (section 211)	dpa DOE	*Negligible Revenue Effect*												
5. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 212)	DOE	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	1	3
6. Frivolous tax submissions (section 213)	[4]	---	3	3	3	3	3	3	3	3	3	3	15	30
7. Regulation of individuals practicing before the Department of Treasury (section 214)	ata DOE	*No Revenue Effect*												
NET TOTAL		**17**	**59**	**102**	**134**	**140**	**147**	**155**	**163**	**174**	**187**	**203**	**601**	**1,483**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:
ata = actions taken after
DOE = date of enactment
dpa = documents prepared after
tyba = taxable years beginning after

[1] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.

[2] Effective dates for provisions relating to reportable transactions and tax shelters: section 101 is effective for returns and statements the due date of which is after the date of enactment; section 102 is effective for taxable years ending after the date of enactment; section 104 is effective for communications made on or after the date of enactment; section 201 is effective for transactions with respect to which material aid, assistance or advice is provided after the section 202 is effective for returns the due date for which is after the date of enactment; section 203 is effective for requests made after the date of enactment; and section 215 is effective for activities after the date of enactment.

[3] Gain of less than $1 million.

[4] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).

Joint Committee on Taxation
June 12, 2002
JCX-63-02

DESCRIPTION OF CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF THE "TAX SHELTER TRANSPARENCY ACT" SCHEDULED FOR A MARKUP BY THE SENATE COMMITTEE ON FINANCE ON JUNE 13, 2002[1]

The Chairman's modification would add the following provision to the Tax Shelter Transparency Act:[2]

A. Modification with Respect to Rite Aid Case

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.[3]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[4]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Modification to the Provisions of the "Tax Shelter Transparency Act" Scheduled for a Markup By the Senate Committee on Finance on June 13, 2002* (JCX-63-02), June 12, 2002.

[2] A description of the provisions of the Tax Shelter Transparency Act can be found at: Joint Committee on Taxation, *Description of Proposals in S. 2498, the "Tax Shelter Transparency Act"* (JCX-53-02), June 11, 2002.

[3] Section 1501.

[4] Section 1502.

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[5]

In the recent case of *Rite Aid Corp. v. United States,*[6] 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. The particular provision, known as the "duplicated loss" provision,[7] 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.

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.[8]

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 not to apply that provision.[9]

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[5] 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. 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).

[6] 255 F.3d 1357 (Fed. Cir. 2001).

[7] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[8] For example, the court stated: "The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[9] The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-

There is a concern that some taxpayers might attempt to take a position that under the language and reasoning of the Federal Circuit Court decision in the *Rite Aid* case, other consolidated return regulations not involved in that case (*i.e.*, to the extent they provide a different result than if corporations had filed separate returns) might now be considered subject to challenge. This might create uncertainty or lead to protracted litigation.

Description of Proposal

The proposal would provide that the regulatory authority provided in section 1502 shall be construed without regard to the interpretation of that authority in the decision of the Federal Circuit Court in *Rite Aid Corp. v. United States.* [10] That is, the proposal would overrule the court's reasoning that there was not a problem resulting from the filing of consolidated returns because a corporate taxpayer could deduct a loss on the sale of stock of a nonconsolidated subsidiary. The proposal would thus deny the case any precedential effect with respect to other consolidated return regulations.

The proposal would nevertheless allow the result of the case to stand, with respect to the specific regulatory provision that was invalidated in the case (Treas. Reg. Sec. 1.1502-20(c)(1)(iii)).

The proposal would confirm that consolidated return regulations may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

The proposal would thus confirm that Treasury is authorized to issue consolidated return regulations utilizing either a single entity or separate entity 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.

Effective Date

The proposal would be effective for all taxable years, whether beginning before, with, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

102740-02, 67 F.R. 11070 (March 12, 2002); *see also*, Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).

[10] 255 F.3d 1357 (2001).

JOINT COMMITTEE ON TAXATION
June 13, 2002
JCX-66-02

ESTIMATED REVENUE EFFECTS OF S. 2498, THE "TAX SHELTER TRANSPARENCY ACT," AS MODIFIED BY THE CHAIRMAN'S MODIFICATION, SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
1. Provisions relating to reportable transactions and tax shelters (sections 101, 102, 104, 201 through 203, and 215) [1]	various dates after DOE [2]	17	56	99	123	126	125	129	134	141	150	162	547	1,262
2. Modification to the substantial understatement penalty (section 103) [1]	tyba DOE	---	---	---	8	11	19	23	26	30	34	38	38	188
3. Actions to enjoin conduct with respect to tax shelters (section 204)	DOE	Negligible Revenue Effect												
4. Understatement of taxpayer's liability by income tax return preparer (section 211)	dpa DOE	Negligible Revenue Effect												
5. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 212)	DOE	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	1	3
6. Frivolous tax submissions (section 213)	[4]	---	3	3	3	3	3	3	3	3	3	3	15	30
7. Regulation of individuals practicing before the Department of Treasury (section 214)	ata DOE	No Revenue Effect												
8. Modification with respect to Rite Aid case	[5]	Negligible Revenue Effect												
NET TOTAL		**17**	**59**	**102**	**134**	**140**	**147**	**155**	**163**	**174**	**187**	**203**	**601**	**1,483**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:
ata = actions taken after
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[1] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.

[2] Effective dates for provisions relating to reportable transactions and tax shelters: section 101 is effective for returns and statements the due date of which is after the date of enactment; section 102 is effective for taxable years ending after the date of enactment; section 104 is effective for communications made on or after the date of enactment; section 201 is effective for transactions with respect to which material aid, assistance or advice is provided after the section 202 is effective for returns the due date for which is after the date of enactment; section 203 is effective for requests made after the date of enactment; and section 215 is effective for activities after the date of enactment.

[3] Gain of less than $1 million.

[4] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).

[5] Effective for all taxable years, whether beginning before, with, or after the date of enactment.

DESCRIPTION OF PROPOSALS IN THE "REVERSING THE EXPATRIATION OF PROFITS OFFSHORE ACT"

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

June 11, 2002
JCX-55-02

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of S. 2119, the "Reversing the Expatriation of Profits Offshore Act", with certain modifications. This document[1] prepared by the staff of the Joint Committee on Taxation, provides a description of S. 2119 the "Reversing the Expatriation of Profits Offshore Act", as modified.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Proposals in the "Reversing the Expatriation of Profits Offshore Act,"* (JCX-55-02), June 11, 2002.

A. Tax Treatment of Inversion Transactions

Present Law

Background

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 is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[2] and the passive foreign investment company rules.[3] 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 earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

In contrast, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law.

Inversion transactions

Some U.S. corporations have reincorporated as foreign corporations in low-tax jurisdictions, thereby replacing the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions, commonly referred to as "inversions," place the corporate group in a position to derive two main U.S. tax benefits: (1) removing some or all of the group's foreign operations and income from the U.S. taxing jurisdiction; and (2) reducing the U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various "earnings stripping" strategies (e.g., making excessive payments of deductible interest or royalties to a new foreign parent). Inversion transactions may take many different forms, including stock inversions and asset inversions.

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, 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 post-inversion structure by reducing U.S.

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[2] Secs. 951-964.

[3] Secs. 1291-1298.

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, subject to certain limitations under present law. These limitations include section 163(j), which limits the deductibility of interest paid to related parties, if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income." More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an "arm's length" standard, and permit the Treasury Secretary to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions themselves may give rise to 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), 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 "toll charge" is reduced.

The transfer by the U.S. corporation 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). 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) 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 tax-free reorganization under the Code.

Description of Proposal

In general

The proposal would define two different types of corporate inversion transactions and would establish a different set of consequences for each type. Certain partnership transactions also would be covered.

Transactions involving at least 80 percent ownership

The first type of inversion would be 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; (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 50 percent or greater ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total business activities of the group. The proposal would deny 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.

In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity would be disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., "hook" stock), this 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, and the definition would not be met. Stock sold in a public offering related to the transaction at issue also would be 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 would be disregarded. In addition, the Treasury Secretary would be granted authority to issue regulations 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 would be granted authority to issue regulations treating certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

Transactions involving greater than 50 percent but less than 80 percent ownership

The second type of inversion covered by the proposal would be 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 would apply to the inversion. Under these rules, the inversion transaction would be respected (i.e., the foreign corporation would be treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure would be strengthened; (2) the IRS would be given expanded power to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to "earnings stripping" through related-party debt, would be strengthened. These measures generally would apply for a 10-year period following the inversion transaction.

Specifically, any applicable corporate-level "toll charge" imposed 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 would be taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits).

With respect to monitoring, the proposal would establish a new pre-filing procedure. Under this procedure, the taxpayer would be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 482, 845, 163(j), and 267(a)(3). The Treasury Secretary would be given the authority to specify the form,

content, and supporting information required for this application, as well as the timing for its submission.

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

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions would apply: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties would be permitted; (2) any transfers or licenses of intangible property to related foreign parties would be disregarded; and (3) any cost-sharing arrangements would not be respected for the taxable year for which the application was required.

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

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

Partnership transactions

Under the proposal, both types of inversion transactions are defined to include certain partnership transactions. Specifically, both prongs of the proposal would apply 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 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 definitions are met, all partnerships that are under common control within the meaning of section 482 would be treated as one partnership, except as provided otherwise in regulations. In addition, in situations in which the strengthened "toll charge" provisions would apply, those provisions would apply at the partner level.

Effective Date

The first prong of the proposal would apply to inversion transactions meeting the 80-percent test that are completed after March 20, 2002. The second prong of the proposal, limiting the benefits of other inversions, would apply to inversion transactions meeting the 50-percent test that are completed after 1996. The measures set forth in the second prong also would apply to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002, effective date of the first prong.

B. Reinsurance Agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[4] 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.[5] 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.

Description of Proposal

The proposal would modify the rules of section 845, relating to authority for the Treasury Secretary to allocate among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal would authorize 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[6] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties, including 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.

Effective Date

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

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[4] Sec. 845(a).

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

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

JOINT COMMITTEE ON TAXATION
June 11, 2002
JCX-56-02

ESTIMATED REVENUE EFFECTS OF S. 2119, THE "REVERSING THE EXPATRIATION OF PROFITS OFFSHORE ACT," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
S. 2119, the "Reversing the Expatriation of Profits Offshore Act" - tax treatment of inversion transactions; reinsurance agreements	[1]	25	81	97	117	140	168	202	242	290	348	418	628	2,128

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[1] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002, and certain insurance risks reinsured after April 11, 2002.

Joint Committee on Taxation
June 12, 2002
JCX-62-02

DESCRIPTION OF CHAIRMAN'S MODIFICATIONS TO THE PROPOSALS IN THE "REVERSING THE EXPATRIATION OF PROFITS OFFSHORE ACT"

Scheduled for a Markup by the Senate Committee on Finance, June 13, 2002

The proposals in the "Reversing the Expatriation of Profits Offshore Act" (as described in JCX-55-02) would be modified as follows:

Certain acquisitions by U.S. corporate groups

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions of the bill generally would 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 would be given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Information reporting

Inverting entities would be required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

JOINT COMMITTEE ON TAXATION
June 13, 2002
JCX-65-02

ESTIMATED REVENUE EFFECTS OF A CHAIRMAN'S AMENDMENT TO S. 2119, THE "REVERSING THE EXPATRIATION OF PROFITS OFFSHORE ACT," AS MODIFIED BY THE CHAIRMAN'S MODIFICATION, SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON JUNE 13, 2002

Fiscal Years 2002 - 2012

[Millions of Dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-07	2002-12
S. 2119, the "Reversing the Expatriation of Profits Offshore Act" - tax treatment of inversion transactions; reinsurance agreements; require inverting entities to provide information to shareholders/partners and the IRS with respect to the tax treatment of the inversion	[1]	25	81	97	117	140	168	202	242	290	348	418	628	2,128

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[1] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002, and certain insurance risks reinsured after April 11, 2002.

Amendments to the Tax Shelter Transparency Act (S.2498)

1	Graham #1	Establish a commission modeled after the IRS Restructuring Commission to examine, review, and simplify international tax rules and the U.S. tax regime as it relates to international income and operations.
2	Graham #2	Amend the tax code to provide that a transaction has "economic substance" only if the transaction changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial nontax purpose for engaging in the transaction.
3	Kerry #1	Strike the Tax Shelter Transparency Act and insert S. 2339 to codify the "economic substance" judicial doctrine and increase penalties on taxpayers, promoters and advisors. S. 2339 would also deny foreign tax credits for taxes paid to tax haven jurisdictions, impose penalties for failing to disclose foreign bank accounts and require a Joint Committee study on the use of offshore tax haven to evade and avoid U.S. tax.

(1)

Graham Amendment #1 to the Tax Shelter Transparency Act (S.2498)

Chairman's Mark

No provision

Graham Amendment

The Graham amendment establishes a Commission on International Tax Equity and Simplification. This bill would enable Congress, the Administration and the U.S. business community to work together to examine, review, and simplify international tax rules, and the U.S. tax regime as it relates to international income and operations.

The Graham amendment and the Commission itself are modeled after the National Commission on Restructuring the Internal Revenue Service. To the extent possible, the language of the amendment replicates the language of the IRS Restructuring Commission bill.

The Commission membership authorizes the appointment of 15 members, as follows:

- President - 5 (Officers or employees of the executive branch, or private citizens or both, not more than 3 members of the same political party)
- Senate Majority Leader - 5 (in consultation w/ Senate Minority Leader; not more than 3 members of the same political party and not more than 2 members may be Members of Congress)
- Speaker of the House - 5 (in consultation w/ House Minority Leader; not more than 3 members of the same political party and not more than 2 members may be Members of Congress)

The Commission is instructed to conduct a review for a period of not longer than 15 months. The Commission should compare current US rules with the rules of other developed countries, consider whether the US should replace its worldwide system

of taxation with a territorial system of taxation, review the present federal income tax laws and make recommendations for improvements in the following areas:

- **Deferral and anti-deferral regimes** — including the need for and effectiveness of anti-deferral regimes in general and the specific elements of any given anti-deferral regime, the overlap among anti-deferral regimes, and the need for multiple anti-deferral regimes;
- **Foreign tax credit regime** — including the foreign tax credit limitation, basketing rules, sourcing rules, and expense allocation rules (in particular, interest allocation rules and the appropriateness of so-called "water's edge" allocation);
- **Transfer pricing rules**;
- **Tax treaty policy** — including whether the United States model treaty represents sound Untied States treatey policy and the need to modernize or revise existing United States treaties or the need to enter into new United States treaties; and
- **Taxation of extraterritorial income (ETI)** — including its compatibility with international trade obligations.

The Commission should deliver it's final report within 15 month after the date of the first meeting, and conclude all activities, including providing testimony to Committees of Congress, within 60 days of the delivery of the final report.

Such sums as may be necessary are authorized to be appropriated for the activities of the Commission.

Rationale

In the past several months, there have been numerous discussions about, and corresponding legislation on tax shelters, corporate inversions, deferral regimes (especially Subpart F), and extraterritorial income (ETI). The Joint Committee on Taxation, the Taxpayer Advocate and many tax professional associations have published reports on tax simplification. Treasury is preparing its own analysis of the current status of international taxation. In addition, the European Union has successfully challenged the foreign sales corporation (FSC) and ETI regimes, opening the door to serious discussion of intrinsic changes to the U.S. system of taxing corporate profits.

The international tax code was written long before globalization. Subpart F, for

example, has not been updated since 1962. The high degree of interest in the tax and business communities indicate that now is the right time to take a more holistic approach to addressing an outdated system. Quick fixes offer immediate gratification but are short sighted in nature. Quick fixes propagate the continuum of the patchwork effect for which our current system has been criticized. Authorizing a Commission to review and modernize the international portion of the tax code in its entirety brings a more rational, long-term perspective to ensuring US competitiveness, fairness, transparency, administrability and compliance. This is the kind of reform that will encourage US-based multinational corporations to continue to remain American companies.

2

GRAHAM AMENDMENT #_2_ to the Tax Shelter Transparency Act (S. 2498)

Chairman's Mark

The Chairman's mark includes the provisions of S. 2498, the Tax Shelter Transparency Act.

Graham Amendment

The Graham amendment includes a clarification of the economic substance doctrine. Under the proposal a transaction has economic substance only if the transaction changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial nontax purpose for engaging in the transaction. The amendment includes increases in penalties applicable to transactions that fail to satisfy the economic substance requirements. The amendment also includes penalties for promoters of transactions that fail to meet the economic substance requirements.

Rationale

S. 2498 relies on greater transparency of tax shelter transactions to allow the IRS to identify potentially abusive transactions and take corrective action. While increased exposure of such transactions will be helpful in discouraging taxpayers from engaging in tax shelters, the IRS needs additional tools to combat the proliferation of tax shelters. One important tool in this effort would be a clarification of the judicially-created "economic substance" doctrine. This clarification, if included in the tax code, would make application of this doctrine uniform among the various judicial circuits.

3

Kerry Amendment # 1 to S. 2498, the Tax Shelter Transparency Act

Short Title

Abusive Tax Shelter and Tax Haven Reform Act of 2002

Text

Strike the Tax Shelter Transparency Act and insert S. 2339.

S. 2339 would: (1) codify the economic substance judicial doctrine, (2) increase the penalty for underpayments resulting from abusive tax shelters, (3) impose a penalty on any substantial promoter of a disallowed tax shelter, (4) impose a penalty on those involved in a disallowed tax shelter if the person advises that the taxpayer's transaction would more likely than not prevail or not give rise to a penalty and the advice is unreasonable, and (5) tighten tax shelter disclosure requirements.

In addition, S. 2339 includes provisions targeting offshore tax evasion. The bill would (1) deny foreign tax credits for taxes paid to jurisdictions that have been identified in a list of uncooperative tax havens to be published by the Treasury Secretary, (2) require that payments over $10,000 to entities, accounts, or individuals that are resident or located in identified uncooperative tax havens be reported on the taxpayer's income tax return, (3) impose a civil penalty of $5,000 for the failure to comply with the rules and regulations requiring the reporting of information requested on the "Report of Foreign Bank and Financial Accounts," and (4) mandate a study by the Joint Committee on Taxation on the use of offshore tax havens to evade and avoid federal income taxes.