"UNCORRECTED"

1 EXECUTIVE COMMITTEE MEETING - S. 1637, THE JUMPSTART OUR
2 BUSINESS STRENGTH (JOBS) ACT
3 WEDNESDAY, OCTOBER 1, 2003
4 U.S. Senate,
5 Committee on Finance,
6 Washington, DC.
7 The meeting was convened, pursuant to notice, at
8 11:16 a.m., in room SD-215, Dirksen Senate Office
9 Building, Hon. Charles E. Grassley (chairman of the
10 committee) presiding.
11 Present: Senators Hatch, Nickles, Lott, Snowe, Kyl,
12 Thomas, Santorum, Smith, Bunning, Baucus, Rockefeller,
13 Daschle, Breaux, Conrad, Bingaman, and Lincoln.
14 Also present: Committee on Finance staff: Kolan
15 Davis, Staff Director and Chief Counsel; Jeffrey A.
16 Forbes, Democratic Staff Director; Mark Prater, Chief Tax
17 Counsel; Russ Sullivan, Democratic Chief Tax Counsel; Ed
18 McClellan, Tax Counsel (Republican staff); Matt Jones,
19 Tax Counsel (Democratic staff); Matt Genasci, Tax Counsel
20 (Democratic staff); Rhonda Sinkfield, Tax Advisor
21 (Democratic staff); and Carla Martin, Chief Clerk.
22 Also present: Pam Olson, Assistant Secretary for Tax
23 Policy, Department of Treasury; George Yin, Chief of
24 Staff, Joint Committee on Taxation; and John Veroneau,
25 General Counsel, USTR.
26

1 OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S.
2 SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE
3
4 The Chairman. The meeting will be called to order.
5 To resolve a problem with a non-related matter to
6 FSC/ETI, I ask unanimous consent that we bring back the
7 pension bill previously reported to the committee, that
8 we change the effective date of the Bingaman COLI
9 provision to the date of enactment. We will hold a
10 hearing on the COLI issue on the week of October 13, with
11 subsequent mark-up of such a bill.
12 Is there any objection? Senator Bingaman?
13 Senator Bingaman. Mr. Chairman, let me say I will
14 not object to your unanimous consent to bring the pension
15 bill back. I do object strongly to the notion that we
16 are going to change the effective date of that COLI
17 provision, because I think by changing it to the
18 enactment date instead of the date when the committee
19 voted on the amendment, I think we set ourselves up to
20 essentially provide an incentive for additional marketing
21 of these corporate-owned life insurance policies between
22 now and the time of enactment. I think that is bad
23 public policy. I think it is an unwise course for us to
24 take.
25 I do appreciate your willingness to have a hearing on

1 the COLI issue and then to have another mark-up on that
2 provision of the bill, because I know there is a lot of
3 confusion among members as to precisely the effect of the
4 provision we adopted.
5 I know Senator Conrad has an amendment that he would
6 like very much to have considered. I think that kind of
7 deliberate approach is the right one. But, as I say, I
8 think we are making a mistake by changing the effective
9 date to the date of enactment.
10 The Chairman. All right.
11 Senator Conrad. Mr. Chairman?
12 The Chairman. The Senator from North Dakota.
13 Senator Conrad. Mr. Chairman, I want to thank the
14 Chairman and the Ranking Member for what has been worked
15 out here, because I do think it is a responsible course.
16 I think we have an absolute obligation to revisit
17 what was done. I think it was one of those cases where
18 the law of unintended consequences has taken hold. The
19 committee's previous action has virtually shut down the
20 COLI market, which I am told is about 20 percent of all
21 new premiums being written. That jeopardizes thousands
22 of jobs and it jeopardizes employee retirement and health
23 benefits. I do not think that was ever the intention of
24 this committee.
25 I think the committee did intend to address

1 legitimate concerns surrounding COLI. That is why the
2 amendment that I have before the committee seeks to do
3 just that, by requiring written consent from the insured,
4 by saying the insured cannot be an hourly worker, by
5 saying the insured must be a participant in or eligible
6 to participate in employee benefit plans, that aggregate
7 coverage must be reasonably related to benefit plan
8 costs, and that an insurance contract must be placed in a
9 trust to fund employee benefits.
10 But I think the better approach, and what I had urged
11 two weeks ago, is that we have a hearing and then we have
12 a mark-up based on the best information available to this
13 committee.
14 I think that is the more responsible course, and what
15 the Chairman and Ranking Member have arranged allows us
16 to do that. I think that reflects well on this
17 committee. I want to thank the leadership for allowing
18 us that opportunity.
19 Senator Nickles. Mr. Chairman?
20 The Chairman. The Senator from Oklahoma.
21 Senator Nickles. Mr. Chairman, I compliment you. I
22 think this is a good solution. I also think GAO is doing
23 a study on COLI, and it would be helpful if the committee
24 could have that information as well.
25 I think a lot of us have learned a lot in the last

1 week or so on this issue, and maybe still have a lot to
2 learn. I have some reservations about some of the
3 proposals that have been advanced, but I think we can
4 make some improvements, with a little more study. I
5 think this is a prudent course of action.
6 The Chairman. The Senator from Montana.
7 Senator Baucus. Mr. Chairman, I, first, thank all
8 the members for their cooperation. This has been a bit
9 difficult to resolve, basically because it is so
10 complicated. A lot of Senators just do not know this
11 matter as well as we would like to. For that reason, I
12 think a hearing is very much a good idea.
13 I think all Senators here recognize the importance of
14 the industry and the jobs, but also recognize that there
15 are potential abuses. We just want to do the right
16 thing. This is a good way to get to doing the right
17 thing, that is, with the hearing and subsequent mark-up,
18 but in the meantime, not shutting down an industry so
19 quickly and so precipitously, but rather trying to do
20 this in an appropriate way.
21 So, I will go back to where I began and just thank
22 you, Senators, for working out this agreement.
23 The Chairman. Without objection, the action that I
24 have described is taking place.
25 Now we turn to the agenda of today's meeting without

1 the distractions. I am going to put my statement in the
2 record.
3 [The prepared statement of Senator Grassley appears
4 in the appendix.]
5 I would turn to Senator Baucus, if he wants to make
6 an opening statement.
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1 OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM
2 MONTANA
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4 Senator Baucus. I will be very brief, Mr. Chairman.
5 I think it is important to just remind ourselves what
6 we are doing today. This is pretty important. We are
7 taking steps to help create and keep jobs in America.
8 With the jobless rate as high as it is, clearly this
9 legislation is going to help. It is not going to solve
10 the problem, but it is certainly going to help.
11 Since February, private sector employment in our
12 country has fallen by about 3.3 million jobs. Those are
13 Department of Labor statistics. Manufacturing has borne
14 the brunt of the downturn. Since its peak in June of
15 2000, manufacturing employment has declined continuously
16 every month for 37 months. Manufacturing alone has lost
17 2.7 million jobs.
18 It is across the country. It is not only in my State
19 of Montana, where 25 percent of our economy is based on
20 manufacturing, but all across the country.
21 Mr. Chairman, today I think we are taking about as
22 good a step as we can take, given the adverse WTO ruling,
23 a ruling which we all know was unfortunate, unfortunate
24 because it was wrong, unfortunate because the European
25 Union, in going to the WTO, breached a commitment that

1 they had made earlier with the United States with respect
2 to really which countries do aid their export sectors.
3 But, having said that, we have to face the situation
4 as it is and play the cards that were dealt. WTO,
5 regrettably, has dealt us this deck of cards that we have
6 to just play the best we can, which means that FSC/ETI
7 replacement legislation, which helps U.S. companies,
8 helps manufacturing, but a way that is WTO consistent,
9 WTO legal. This legislation has done that.
10 I am also pleased, Mr. Chairman, that the mark
11 includes provisions that Senator Hatch and I have worked
12 on over the years with respect to some international
13 provisions that are also in this bill. I am pleased,
14 too, that the modification to the mark expands relief to
15 partnerships and sole proprietorships.
16 Too often, small business is not given enough
17 attention in major tax legislation like this. We have
18 said to small business, we hear you. You are part of the
19 country, too. You, too, small business manufacturers,
20 and not only large business, big business, should get
21 some benefit.
22 Thank you again, Mr. Chairman, for working so well to
23 put together a bill which I think is going to pass this
24 committee unanimously.
25 [The prepared statement of Senator Baucus appears in

1 the appendix.]

2 The Chairman. Thank you, Senator Baucus. I would
3 also like to thank you and everybody on this committee,
4 because this bill has come out with much more of a
5 consensus than, a year ago, I thought was possible.

6 But if Senator Baucus remembers when he was chairman
7 that we worked together on this and I suggested the
8 establishment of a working group so we would get
9 everybody that had an interest in this under the umbrella
10 and see if we could settle differences. Both within this
11 committee and with outside sectors, I think to a great
12 deal we have accomplished that.

13 So, I thank, particularly Senator Baucus for his
14 leadership last year as he started this process off, and
15 working with me to where we are today.

16 So I would call up the Chairman's mark which amends
17 S. 1637. Since the Finance Committee staff and members
18 have met regarding the basic Chairman's mark and reviewed
19 its details, I want to forego the Finance Committee staff
20 walk-through of my Chairman's mark.

21 On Monday, members filed 111 amendments to the mark.
22 I want to thank members for their cooperation through
23 this process, and hope we see continuation of that
24 cooperation through this mark-up.

25 The Finance Committee staff met on these amendments.

1 The staff attempted, as best they could with the revenue
2 available, to accommodate interests of individual
3 members. Those accommodations were derived from your
4 comments and the comments of your staff.
5 As I saw it, members raised three big issues
6 concerning the bill before it: the elimination of the
7 domestic foreign haircut occurred too late, 2012; second,
8 there should be more resources devoted to the
9 international reform package; third, proprietors and
10 partnership manufacturers should be included in the
11 manufacturing deduction.
12 Some of you raised concerns about the transition
13 period, others asked for the expansion of the
14 manufacturing definition. With the exception of
15 additional transition relief, we were able to address
16 most of these big-picture priorities.
17 Were we able to do everything that everyone wanted,
18 including even everything that I would want in this mark?
19 The answer is no. The modification to the Chairman's
20 mark, however, includes, I believe, a fair balance of
21 these priorities. Aside from these big picture areas, I
22 was pleased that members, by and large, filed amendments
23 that were related to domestic manufacturing or
24 international reform. Within the revenue available, we
25 attempted to accommodate these interests.

1 Now I would like to turn to the staff walk-through of
2 the modification. We have before us Pam Olson of
3 Treasury, George Yin of Joint Tax, Ed McClellan of the
4 Finance staff, Republican, and Max Genosci, of the
5 Finance Committee Democratic staff.
6 Mr. Yin, I will ask you to walk through the
7 modifications. The document is quite lengthy, so please
8 focus on just a brief, general description of the major
9 areas.
10 Mr. Yin?
11 Mr. Yin. Thank you, Mr. Chairman. I am going to
12 work off of the Table of Contents to the modification
13 document, which is JCX-85-03, dated today. It's
14 entitled, "Modification of the Chairman's Mark on the
15 JOBS Act."
16 The first major item is on page 2. It relates to
17 some changes to the manufacturing deduction that was in
18 the Chairman's mark. As the Chairman indicated, it
19 extends the deduction to partnerships and sole
20 proprietorships, but limits the deduction of any
21 business, no matter how organized, to 50 percent of wages
22 paid.
23 For partnerships, the allocation of the deduction
24 must be consistent with the allocation of qualified
25 production activities income. It extends the deduction

1 to apply to unprocessed timber and oil and gas refining.
2 As the Chairman indicated, it accelerates the phase-out
3 of the domestic worldwide fraction, to begin in 2010
4 instead of 2012.
5 There is a clarification to the document relating to
6 oil and gas. There is no restriction on taxpayers who
7 have petroleum refining operations by reason of the size
8 of their operations or whether they are engaged in the
9 retail sale of fuels.
10 The second item is an item on page 17. It relates to
11 the temporary rate reduction for certain dividends
12 received by CFCs. This provision allows certain actual
13 and deemed dividends received by a U.S. company from a
14 CFC to be taxed at a reduced rate of 5.25 percent.
15 There's a limited period of time in which the
16 distribution has to take place, and there is also a base
17 period limitation in the distribution subject to this
18 reduced rate. It has to exceed some base period amount.
19 This item was approved by the Senate in connection with
20 JEGTRA earlier this year.
21 The third item, is on page--
22 Senator Nickles. Can I interrupt for just a second?
23 Mr. Yin. Yes.
24 Senator Nickles. So this is a one-year window.
25 Mr. Yin. I believe it's less than one year. I

1 think it is 120 days.

2 Senator Nickles. I thought the proposal was for one

3 year. This is a repatriation?

4 Mr. Yin. Yes. Correct.

5 Senator Nickles. And the tax on repatriated income

6 would be 5.25 percent?

7 Mr. Yin. That is correct, sir.

8 Senator Nickles. And it is only 120 days?

9 Mr. Yin. There is a window of time. I believe it

10 is 120 days.

11 Senator Nickles. I am reading it now. It is 120.

12 But I thought it was always discussed as being a year

13 window. What was the reason?

14 Senator Hatch. Perhaps I can help there. I wanted

15 the Hatch amendment to allow that for one year and then

16 go from there, but it would have cost up to $2 billion,

17 as I understand it, additionally. That is why it was

18 kept off. Is that correct?

19 Mr. Yin. That is correct, Senator.

20 Senator Hatch. I think that would make better tax

21 policy, but I understand why you kept it off, because of

22 the mark.

23 Senator Nickles. This is kind of a big deal. Let

24 me make sure I understand it. I want to compliment the

25 Chairman. I think he committed, some time ago, to have

1 repatriation in it. I believe, and I have heard
2 estimates, that there might be as much as $300 billion,
3 or something. Is that estimate confirmed, or close?
4 Mr. Yin. I cannot confirm that estimate. But in
5 terms of the window period that you are referring to, my
6 understanding is that this is the window period that was
7 provided in the Ensign bill and that this is the
8 provision that is----
9 Senator Hatch. That is false. That is not correct.
10 Senator Bunning. That is not true.
11 Senator Nickles. Now, I am just going on memory. I
12 remember the discussion in the committee, but I thought
13 it was a one-year window. Now, four months may be
14 sufficient or it may not be sufficient. I am not sure.
15 But this is a big deal if you are talking about
16 hundreds of billions of dollars. I do not know why it
17 should be compressed in that tight of a timeframe. You
18 would be compelling a lot of big decisions by corporate
19 boards and others.
20 I just want to learn a little bit more. I am not
21 saying it is incorrect or not the right thing to do. I
22 just noticed when I was reading through it, I said, that
23 does not look like what I was expecting.
24 Mr. Yin. Well, Senator Nickles, maybe I need to
25 clarify myself. If you will notice, on page 17, the

1 specific description of the period is right in the middle
2 of the page.
3 It is in the first paragraph under "Description of
4 Proposal," and it is the last sentence of that paragraph.
5 It says, "This rate reduction is available only for the
6 first taxable year of any electing taxpayer, ending 120
7 days or more after the date of enactment of the
8 provision."
9 Senator Nickles. All right. So they have a full
10 taxable year. Their corporate year may be January, but
11 it may well be March, so they do have an entire year.
12 All right. I appreciate that.
13 Mr. Yin. I am sorry for the confusion, sir.
14 The Chairman. Senator Smith?
15 Senator Smith. Mr. Chairman, I thank Mr. Yin for
16 that clarification, because I join Senator Nickles in the
17 alarm. If you cut it back, you are cutting back on job
18 creation. It is just that clear. I think, as a
19 practical matter, companies are going to need a year in
20 order to derive the full benefit to the economy.
21 We are literally talking between 400,000 and a half a
22 million jobs to be created in that period of time. So,
23 if gross domestic product growth means anything, this
24 ought to be left intact.
25 Senator Nickles. Yes.

1 Senator Bingaman. Mr. Chairman?
2 The Chairman. Senator Bingaman, then I will come
3 back to Senator Nickles, then Senator Breaux.
4 Senator Bingaman. Could I just have staff clarify
5 what you are now including in the bill on this
6 repatriation? It is the maximum tax, or the tax that
7 would be payable by corporations on foreign-owned income
8 or foreign-earned income would be 5.25 percent, as long
9 as they repatriated the funds in the next quarter. Is
10 that right?
11 Mr. Yin. Within the period of time that I just read
12 that was specified on page 17, the first taxable year
13 ending within 120 days after date of enactment. It would
14 only apply to distributions in excess of some base period
15 amount of prior repatriations that the company has made,
16 and that base period amount would be determined over the
17 prior five years, some averaging of the amount over that
18 prior five years.
19 Senator Bingaman. Is there any thought that this is
20 sort of a one-time repatriation provision? In the
21 future, why would we not be urged vigorously to make this
22 a permanent provision?
23 Mr. Yin. You may well be urged to do that, Senator
24 Bingaman. [Laughter].
25 Senator Bingaman. And then you have a substantially

1 lower tax being charged for income earned overseas than
2 for income earned by manufacturing in this country. It
3 seems to me that it goes contrary to the purpose of our
4 bill.
5 As I understand the purpose of our bill, it is to
6 encourage manufacturing here. If we set up a tax
7 structure which says you get a lot better tax treatment
8 if you manufacture overseas instead of here----
9 Senator Smith. Mr. Chairman, if I might, as the
10 author of this provision. These revenues are taxed
11 overseas. We are just trying to get them back here so
12 that they can manufacture here. We are creating this
13 window to get money and capital back here so labor can go
14 to work.
15 Senator Bingaman. But you get a tax credit for the
16 tax you pay overseas against the U.S. tax. So if the
17 U.S. tax is 30 percent today and you paid 15 percent
18 overseas, your effective rate when you bring it back is
19 15 percent.
20 We are now saying the maximum rate you are going to
21 have to pay when you bring the money back to this country
22 is 5.25 percent, regardless of anything else. Does that
23 not create an incentive for more companies to do more
24 manufacturing overseas?
25 Senator Smith. We are not doing it prospectively,

1 we are doing it retroactively, because we are trying to
2 get the money back into this country to create American
3 jobs.
4 Senator Bingaman. Yes. But I am saying, if in fact
5 the committee, the Congress, and everyone is urged to
6 make this a permanent provision so that we have a
7 differential tax rate which gives a preference to those
8 companies that do their manufacturing overseas, does not
9 that not go contrary to the purpose of the bill we are
10 trying to enact?
11 Senator Smith. It is not just manufacturing. It is
12 services and all kinds of jobs. Frankly, too many jobs
13 have gone overseas. We are trying to get them back here.
14 It gives them a window of time to create what J.P. Morgan
15 and others have estimated would be a half a million jobs.
16 I think that that is significant. That is something we
17 ought to care about. I think it costs us very little in
18 the end in terms of what it can produce for people.
19 The Chairman. All right. Senator Bingaman, have
20 you made your statement?
21 Senator Bingaman. Yes, I have. Thank you, Mr.
22 Chairman.
23 The Chairman. All right. Then Senator Nickles,
24 now, then Senator Breaux, then Senator Rockefeller.
25 Senator Nickles. Mr. Chairman, thank you. I

1 appreciate the clarification, because when I was first
2 reading this I thought, 120 days, I am not sure that is
3 going to work.
4 Let me just ask Mr. McClellan a quick question, or
5 Mr. Yin. Japan, France. Do they tax income that is
6 generated overseas and brought back to their country? Do
7 they even tax it?
8 Mr. McClellan. I do not know about Japan, Senator
9 Nickles. But, generally, France and other countries,
10 like Germany, maintain what is called a territorial
11 system, meaning that their taxation stops at water's edge
12 and they do not tax the overseas earnings of a
13 corporation based in their country.
14 Approximately one-half of the member countries in the
15 OECD are territorial tax systems, the other half follow
16 the U.S. system of worldwide taxation.
17 Senator Nickles. All right. I appreciate it.
18 Mr. Chairman, I had some reservation. I think
19 Senator Bingaman's question that still lingers in my mind
20 is, all right, we are doing this once and it will
21 probably generate a lot of activity. People will think,
22 I am not sure this window will open or not.
23 I do expect that there will be hundreds of billions
24 of dollars brought back to this country that, frankly,
25 are sitting in other countries and they are not going to

1 bring them back if they are subject to tax at the rates
2 that we are looking at today. I think that can help the
3 economy.
4 Senator Smith alluded to the fact that it could be a
5 half a million jobs. It could be more than that if you
6 are talking about that kind of capital infusion into the
7 country at a time I think our economy could use it.
8 I am concerned, though. It is almost like the tax
9 holiday type environment. I would like to see us maybe
10 move more to a territorial type system. I think there is
11 some good work done on this bill, but I think, in looking
12 at our tax system and comparing it to other countries, we
13 could still have some improvements to do. Maybe if we
14 are on more of a territorial type system, it might be
15 more advantageous, more competitive.
16 Senator Bingaman. Mr. Chairman, can we hear from
17 Treasury on this?
18 The Chairman. Ms. Olson, we need to have you
19 respond to that. But go ahead, first, Senator Breaux.
20 Senator Breaux. Thank you very much, Mr. Chairman.
21 I appreciate the authors of the bill for what they
22 are attempting to do, but I have got to go back to
23 Louisiana and try and explain this. As I understand it,
24 I mean, if I have got two companies in my State of
25 Louisiana and one that manufactures widgets in Louisiana,

1 they pay 35 percent corporate tax.

2 But if another company in Louisiana that makes

3 widgets picks up and moves to Mexico and makes the

4 widgets over there, closing the plant in my State of

5 Louisiana and makes the widgets in Mexico, I am going to

6 tell them that the money they make on manufacturing

7 widgets in Mexico, they only pay 5 percent tax.

8 So the company that left is going to have to pay a 5

9 percent tax on the money they make, the company that

10 stayed in Louisiana, that creates jobs in Louisiana, has

11 got to pay 35 percent income tax. I cannot explain that.

12 Particularly, I cannot explain it when the fact is,

13 as I understand the bill, when you bring the money back

14 you can use it for anything you want. You can use it for

15 repurchasing your stock to increase the value of deferred

16 compensation packages, for instance. You can do it for

17 whatever you want. You can use it to increase your

18 profit line.

19 You do not have to use it to create more jobs. You

20 do not have to use it for research and development. You

21 do not have to use it to hire more workers or buy more

22 equipment. You could just use the entire amount to

23 repurchase stock to increase the stock option packages.

24 Is that not correct?

25 Mr. McClellan. That is correct, Senator.

1 Senator Breaux. I cannot sell that in my State of
2 Louisiana. To say that a company that leaves my State is
3 going to somehow be able to produce products and only pay
4 a 5 percent tax, but a company that stays in my State and
5 hires people in my State is going to have to pay a 35
6 percent tax, if that is not an incentive to leave, I do
7 not know what is.
8 And we are trying to find ways to incentivize them
9 staying here and recreating manufacturing jobs in this
10 country. There is no other segment of our population
11 that has suffered more than manufacturing, and this is a
12 disincentive for them to stay here.
13 Because, as we all know, if we do it for one year
14 they will be back the next year to make it the second
15 year, the third year, and ad infinitum. So I just think
16 this is bad policy.
17 So I just think this is bad policy. I am going to
18 have an amendment to this dealing with what the monies
19 can be used for when they bring it back. I think, even
20 with my amendment, it is not good policy.
21 The Chairman. Well, do you want to respond to that?
22 Senator Smith. Yes.
23 The Chairman. All right. Senator Smith. Then we
24 will go to Senator Rockefeller.
25 Senator Smith. Well, this cannot be used for

1 repurchasing stock. It can only be used in a domestic
2 reinvestment plan approved by the taxpayer's president,
3 chief executive officer, or comparable official before
4 the payment of such dividends and subsequently approved
5 by the taxpayer's board of directors, management
6 committee, executive committee, or similar body, which
7 plan shall provide for the reinvestment of such dividends
8 in the United States, including as a source for funding
9 of worker hiring and training; infrastructure; research
10 and development; capital investments; or the financial
11 stabilization of the corporation for the purposes of job
12 retention or creation, over the base divided amount.
13 Senator Breaux. Can I ask him what financial
14 stabilization is? Is that not a window I can run
15 anything through?
16 Senator Smith. Well, I think it is for purposes of
17 job creation and stabilization.
18 Senator Breaux. Financial stabilization. I could
19 repurchase stock and call it financial stabilization of
20 the company because it increases the value of the stock.
21 Senator Smith. If it keeps a company out of
22 bankruptcy and keeps people employed, I think that is
23 what I am interested in. That is the motivation for
24 this.
25 Senator Breaux. To increase the value of stock.

1 Senator Smith. And, frankly, most of the companies
2 we are talking about, they have manufacturing here and
3 they have manufacturing abroad. We are trying to get
4 more of it back here so we can do more of it here.
5 The Chairman. All right. Senator Rockefeller?
6 Senator Rockefeller. Mr. Chairman, I just want to
7 take, after what John Breaux and Jeff Bingaman discussed,
8 we do not make widgets in West Virginia, but I am going
9 to use that example.
10 I am going to ask the Joint Tax Committee rather than
11 Treasury. Mr. Yin, if you will answer these questions.
12 If we do produce in West Virginia widgets, what will be--
13 I just want to get you on record--the top corporate tax
14 rate that they would pay?
15 Mr. Yin. Well, the regular corporate tax rate is 35
16 percent. If this manufacturing deduction were enacted,
17 then there might be some reduction to that.
18 Senator Rockefeller. All right. And the same as
19 Senator Breaux indicated. If the same widget making were
20 undertaken in Mexico or China, what would be the
21 corporate tax rate that they would pay in that
22 circumstance?
23 Mr. Yin. Well, they would pay whatever the rate of
24 tax is in Mexico or China, and then on repatriation they
25 would pay this reduced rate of tax, assuming that they

1 had standing, subject to the bill.

2 Senator Rockefeller. Which is 5.25 percent?

3 Mr. Yin. It is 5.25 percent. Correct.

4 Senator Rockefeller. All right. So, I just think

5 it is fairly powerful. We have got eight million people

6 unemployed. I do not think access to capital is the

7 problem here for us to be doing this. I agree with

8 Senator Breaux.

9 I do not know how I would possibly explain that in

10 West Virginia, not for political purposes, but just

11 people saying, well, what are you people doing up there?

12 We have lost 15,000 jobs in the last two years,

13 manufacturing jobs, in West Virginia.

14 Thank you, Mr. Chairman.

15 The Chairman. Could I do two things? First of all,

16 we do not have an amendment before us and I assume we

17 would have an amendment before us. I would like to

18 debate the amendments when the amendments come up. We

19 are in the walk-through now and we would like an

20 explanation.

21 Senator Hatch. Mr. Chairman?

22 Senator Santorum. Mr. Chairman?

23 The Chairman. Senator Hatch, then Senator Santorum.

24 Senator Hatch. Just on Senator Rockefeller's and

25 Senator Breaux's point.

1 The Chairman. I guess we will not have to make the
2 point when the amendments come up. [Laughter].
3 Senator Hatch. Right now, they do not bring it
4 back. That is current law. They do not bring the money
5 back. This is an incentive to have the money come back.
6 Senator Breaux. Would the gentleman yield on that
7 point?
8 Senator Hatch. Sure.
9 Senator Breaux. But to show you the difference and
10 the discrimination factor, some companies do bring their
11 money back. When they do bring it back, now they pay 35
12 percent. They have been following the law.
13 Now we are saying, if you kept it over there and now
14 we pass this, now you can bring it back and get a huge
15 advantage over people who have been bringing it back
16 paying the regular rate, and we are going to give you a
17 special deal because you kept it over there longer and
18 only have to pay 5 percent. Some companies do bring it
19 back and they pay the higher rate.
20 Senator Hatch. Well, I agree with that. But the
21 vast majority do not. That is one way we get this money
22 back in just a one-year thing.
23 Now, I have been against having it more than one
24 year. My amendment to keep it and guarantee it is only
25 one year, I think, would be supported, but it does cost a

1 few bucks, according to Joint Tax.

2 Senator Breaux. I am afraid it will be one year at

3 a time.

4 The Chairman. Senator Santorum?

5 Then Secretary Olson, to respond to what Senator

6 Nickles said. Then back to Mr. Yin.

7 Senator Santorum. I would just make the brief

8 comment, I do not think you are creating an incentive

9 when you are making the provision retroactive, not

10 prospective. You are not incentivizing anybody to move

11 anything offshore. All you are doing is recognizing the

12 fact that there are revenues and profits being made

13 outside of the United States.

14 We would like to see that money come back to the

15 United States. We are not creating any incentive to do

16 so in the future because we are putting in a very small

17 window of opportunity to bring that money back.

18 So, the idea that somehow or another I have to go and

19 say, well, in the future we are going to be taxing 5

20 percent versus 35, that is not the case. The money has

21 been made.

22 The question is, what do you want to do with it? Do

23 you want to leave it there or do you want to bring it

24 back here to create jobs? My feeling is, I think it is a

25 pretty simple question.

1 The Chairman. Secretary Olson?
2 Ms. Olson. Thank you, Mr. Chairman.
3 The administration does share the concerns that have
4 been expressed by Senator Bingaman and some of the others
5 on the committee.
6 Senator Rockefeller. Can you pull that mic up just
7 a bit?
8 Ms. Olson. Certainly.
9 Senator Nickles. Senator Smith asks that you push
10 the mic away. [Laughter]
11 Ms. Olson. Which would you like me to do, push it
12 closer or further away?
13 We do share the concerns that have been expressed by
14 Senator Bingaman and some of the other members of this
15 committee about the fairness of this provision.
16 Companies that invested abroad knew what the tax rules
17 were when they made their investments, and now we are
18 giving them a holiday from the results of the decisions
19 that they made.
20 It does set the companies who would take advantage of
21 this against companies who have, over their years, paid
22 their taxes, repatriated their income, and paid their
23 taxes here in the U.S.
24 We are somewhat skeptical about the purported
25 economic benefits from the holiday and we think that it

1 is going to undermine taxpayers' feelings about the
2 fairness of the Tax Code and the IRS's ability to enforce
3 the rules in the future.
4 The Chairman. Mr. Yin?
5 Mr. Yin. Thank you, Mr. Chairman.
6 Back to the modification document. The third item I
7 will mention is on page 31. This provision would repeal
8 the personal holding company rules for the same period of
9 time in which the dividends are taxed under reduced rates
10 as a result of the JEGTRA provision enacted earlier this
11 year.
12 The fourth item, is on page 34. I need to clarify
13 that this item sunsets after five years. The write-up in
14 the modification is not complete on that point.
15 The fifth item, is on page 56. This is an item that
16 was previously approved by the Senate Finance Committee
17 and would modify the requirements for property and
18 casualty insurance companies to be eligible for tax-
19 exempt status and to elect to be taxed only on taxable
20 investment income.
21 The next item is on page 64 and it deals with the
22 charitable contribution of patents and similar property.
23 This provision would generally provide that the
24 charitable contribution of patents and similar property
25 may not exceed the taxpayers' basis in the contributed

1 property.

2 The next item is on page 66. This provision, which

3 was previously agreed to by the Senate, is to extend

4 certain merchandise processing fees and COBRA fees

5 through September, 2013.

6 The next item is on page 70, and would repeal the 10

7 percent rehabilitation credit for older, nonhistoric

8 buildings. This was previously approved by the Senate in

9 connection with the JEGTRA law.

10 The next item is on page 73, and would extend the so-

11 called kiddie tax provisions to minors under the age of

12 18.

13 The next item is on page 76, and would generally

14 require that organizational and start-up expenses that

15 are not deductible must be amortized over a 15-year

16 period.

17 The next item is on page 78. This provision would

18 limit the amount of allowable deductions or losses with

19 respect to certain service contracts or leases to the

20 amount of income reported with respect to such service

21 contract or lease. The provision applies only to certain

22 leases with respect to domestic or foreign governments

23 and municipalities, as well as tax-exempt organizations.

24 The next provision is on page 79. This provision

25 substitutes for a provision that is in the Chairman's

1 mark and would require that, upon certain partnership
2 distributions and transfers of partnership interest,
3 there would have to be an inside basis adjustment to the
4 partnership assets.
5 In addition to these provisions, I need to mention
6 three additional provisions which are described in an
7 addendum. This is in a Joint Committee document, JCX-87-
8 03. This contains three additional items that are
9 included in the Chairman's modification.
10 The first item would extend the phase-out for Section
11 179 expensing to allow some benefits to taxpayers with
12 $600,000 of qualified investment. The second item in the
13 addendum is to provide that, for losses arising in 2003,
14 they are provided a three-year net operating loss carry-
15 back period instead of two years.
16 The last item relates to private debt collection and
17 provides that the IRS has the authority to use certain
18 private debt collection companies to locate and contact
19 taxpayers owing outstanding tax liabilities.
20 That completes my description of the Chairman's
21 modification and addendum.
22 The Chairman. I would now move the Chairman's mark.
23 Without objection, the Chairman's mark is modified.
24 Now, while we did accommodate most of the members'
25 interests in the modification, there are some issues that

1 members wanted to debate. We would now turn to the
2 offering of those amendments.
3 Senator Breaux?
4 Senator Breaux. I have an amendment, Mr. Chairman,
5 a second-degree amendment. Is it Senator Gordon Smith
6 who has the amendment on the repatriation?
7 The Chairman. It is in the Chairman's mark, so you
8 will be a first degree. Yes.
9 Senator Breaux. To his. All right. I have got
10 some other things, but I am not ready yet.
11 The Chairman. Senator Breaux, we need to find
12 Senator Smith because he was going to oppose your
13 amendment.
14 Senator Breaux. But my amendment is in order,
15 right?
16 The Chairman. Yes, your amendment is in order. Why
17 do you not begin debating your amendment?
18 Senator Breaux. Yes. We sort of already had the
19 debate, but I do not mind doing it again.
20 The question I had, I would say to the Chairman, to
21 the Ranking Member, and others, is very simple. We have
22 heard Treasury say that the concept of bringing money
23 back retroactively when companies knew what the rules
24 were, and saying that you can bring it back, I think for
25 just about any purpose, is not good public policy.

1 Many U.S. companies have brought back foreign
2 earnings and paid the regular tax rate, 35 percent, minus
3 what they paid overseas.
4 To give companies retroactively an asset like this
5 amendment would do, I think, as Treasury said,
6 discriminates against those who play by the rules,
7 knowing what the rules were.
8 So, that is the major point about why we should not
9 support this and let this happen. At least restrict the
10 amount of money coming back to that which would not have
11 come back had it not been for this legislation. If the
12 money does come back, restrict it to some use that
13 guarantees it is going to be put to productive use in
14 this country.
15 So, my amendment to the Smith amendment addresses
16 that by saying, number one, that the repatriation
17 proposal would be limited only to bringing back money in
18 excess of the taxpayers' average repatriation over three
19 of the five most recent taxable years.
20 In other words, if they were already bringing it
21 back, you could say you would let them bring it back tax-
22 free, except the 5 percent, there ought to be some
23 relation to what they were doing before. So, there is a
24 limitation on what they can bring back over what they
25 were already bringing back under the old system.

1 The most important feature, I think, of my amendment
2 would say, however, that we are going to say that if the
3 money comes back and we give them this special privilege,
4 it should be limited to purposes of creating jobs and
5 doing things that try to improve the economy of this
6 country.
7 So my amendment would say that there would be a cap,
8 that if the money coming back is used for increasing the
9 number of workers or for capital expenditures within the
10 United States, or spending on research and development,
11 which is a big item, and for contributions to a defined
12 benefit pension trust, that those are things that would
13 make them eligible for the lower tax rate.
14 I am very concerned that, under the current language,
15 if that is not the author's intent, he should be
16 supportive of this amendment because I am concerned about
17 the money being able to be brought back to, for instance,
18 repurchase stock or to simply increase the financial
19 viability of the company, whatever that means.
20 I could imagine some of the money coming back at this
21 lower rate being used to grant everybody a huge salary
22 increase who happens to be an office of the corporation,
23 but nobody else. I mean, certainly we do not want that
24 to happen.
25 So my amendment say, all right, if you are going to

1 allow the one-year repatriation, it should be limited to
2 the purposes of increasing the number of wage employees,
3 for capital expenditures within the United States, for
4 research and development, or for contributions to a
5 defined benefit pension trust fund for the workers.
6 Now, let me ask Treasury. You probably still do not
7 like it, even with my amendment.
8 Ms. Olson. That is correct, Senator. [Laughter]
9 Senator Breaux. So that shows you how bad this deal
10 is. Even with my amendment to improve it and say it is
11 only going to be used for these defined purposes,
12 Treasury still thinks it is bad policy.
13 But at least it would say that, if the money comes
14 back, it is going to be used for these purposes. The
15 savings that we would generate out of this would be used,
16 under my amendment, to phase out the benefit haircut
17 faster under the Chairman's mark.
18 The Chairman: What I would ask now is that we would
19 set aside this amendment until Senator Smith comes.
20 Then would you go ahead with your Puerto Rico
21 amendment at this point?
22 Senator Breaux. This is an amendment, probably,
23 that the Senator from Pennsylvania may join. I think it
24 could probably be considered a Breaux-Santorum or
25 Santorum-Breaux amendment, whatever gets us the most

1 votes. [Laughter]

2 The Chairman. We are prepared to accept your

3 amendment.

4 Senator Breaux. I will not say another word.

5 Senator Santorum. Thank you, Mr. Chairman.

6 Senator Baucus. No.

7 The Chairman. There is another Puerto Rico

8 amendment.

9 Senator Breaux. Let me just explain the amendment,

10 and perhaps we can figure out which one I am offering. I

11 will take the first offer, though, of accepting it.

12 [Laughter]

13 I will go ahead and just present the amendment so

14 everybody will know what we are talking about. This is

15 sort of a repatriation amendment as well, which I just

16 spoke about repatriation. But it is a repatriation that

17 is not retroactive. It is prospective only. One of the

18 big defects in the previous amendment on repatriation for

19 one year, is that it is retroactive.

20 This amendment dealing with the Commonwealth of

21 Puerto Rico is prospective only. It would say that

22 companies that now are looking for setting up operations

23 outside of the continental United States, I mean, a lot

24 of them are moving to other countries that have no

25 connection to the United States.

1 What I am saying is, Puerto Ricans are citizens of
2 this country. We have an obligation to help them with so
3 many different areas. It is getting to be more of a
4 problem.
5 So, what we are trying to do is say, all right, if we
6 are going to have manufacturing done outside of the
7 continental United States, I would rather have it done in
8 Puerto Rico to benefit the citizens of Puerto Rico which
9 are citizens of the United States.
10 So, my amendment would simply say that taxable income
11 that is earned because of operations in the Commonwealth
12 of Puerto Rico, when that money comes back to the United
13 States, it would come back at a deferred tax rate and it
14 would be the 5 percent tax rate when they bring it back.
15 Mr. Yin, could you comment on that? I want to make
16 sure I got the numbers correct on my amendment.
17 Mr. Yin. I believe that you described it correctly,
18 Senator. It would amend the so-called Section 956 rules,
19 which would otherwise impose a U.S. tax on a repatriation
20 of that sort and would reduce the tax that would apply in
21 that situation.
22 Senator Breaux. And the difference is, these are
23 citizens of the United States that we are trying to help.
24 If we are going to have a company that is going to locate
25 outside of the United States and they have a choice

1 between some of the islands or some other foreign country
2 or Mexico, I would much prefer them, if they are going to
3 make that decision, to do it in the Commonwealth of
4 Puerto Rico, and that we have an obligation to
5 participate and to try and help. They are citizens of
6 this country, and that is why we offer this amendment. I
7 am joined with my colleague, Senator Santorum, on this.
8 Senator Nickles. Mr. Chairman?
9 The Chairman. We ought to let Senator Santorum
10 speak as a co-sponsor before we go to questions.
11 Senator Santorum. Thank you, Mr. Chairman. I thank
12 the Senator from Louisiana for offering the amendment on
13 our behalf. I would just say that the unemployment rate
14 in this country is hovering around 6 percent.
15 The unemployment rate in Puerto Rico is hovering
16 around 11 or 12 percent, double what the unemployment
17 rate is here. These are U.S. citizens. We brought this
18 provision up, as you will recall, in a previous tax bill.
19 We were told that it should have been offered under
20 the foreign tax bill, which, candidly, I do not believe
21 it should be offered under because Puerto Rico is a U.S.
22 territory. However, we were told that was the
23 appropriate place. We have waited and bided our time to
24 be able to bring that up here.
25 But if we are concerned about U.S. citizens and

1 helping places that have particularly high unemployment,
2 this is a provision that is a provision targeted toward a
3 very high unemployed area and I think is something that
4 has been a policy in the past to try to do some things to
5 help Puerto Rico.
6 We have basically repealed a lot of those incentives
7 to manufacture in Puerto Rico. We would like to
8 reinstate those so those jobs do not go offshore, do not
9 go to Mexico, do not go to other foreign countries, but
10 stay here in the United States and help U.S. citizens.
11 Senator Nickles. Mr. Chairman?
12 The Chairman. Senator Nickles?
13 Senator Nickles. Mr. Chairman, just a couple of
14 comments. One, I am sympathetic to trying to do
15 something to help Puerto Rico. We did repeal 936. I
16 supported that repeal because I thought it was very
17 expensive on a per-job basis.
18 But I find Senator Breaux's comments a little
19 interesting, because he said, well, we are going to have
20 some inconsistency and maybe encourage U.S. plants to
21 locate outside, especially if we did repatriation.
22 Well, repatriation--correct me if I am wrong, or
23 staff correct me if I am wrong--in the Chairman's mark
24 would repatriate money that is already overseas that has
25 been sitting overseas, and frankly in many cases has been

1 sitting overseas for years and years, but it is not
2 prospective. It is basically for tax years 2003 and
3 before.
4 In other words, there is not one company that would
5 benefit or they would be gambling if they said, all
6 right, now we are going to move a domestic plant and put
7 it overseas because we think we might be able to
8 repatriate the income at 5 percent, because that is not
9 the case. We have not changed the law prospectively.
10 The corporate rate is still 35, or maybe 32, depending on
11 what we do.
12 But this bill or this amendment, this proposal, would
13 prospectively say that if you moved a plant from the
14 United States into Puerto Rico, prospectively the tax
15 rate would be 5 percent. There would be real incentive
16 to relocate plants from the United States to Puerto Rico.
17 We did not do that.
18 That is not in the Chairman's mark. It is
19 retroactive and the authors have said it is one time, so
20 companies cannot assume that, in the future, if they move
21 overseas, they are going to be able to bring back a rate
22 of 5.25 percent.
23 But under this amendment, just so people will know, I
24 just find it a little inconsistent. This amendment,
25 prospectively, there is an encouragement to locate, or

1 possibly relocate facilities.

2 Now, I am interested. Puerto Rico is part of the

3 United States. They are U.S. citizens. Their economy is

4 very poor compared to the rest of the United States. I

5 started to say they paid taxes. They do not pay U.S.

6 income taxes, but they are citizens of the United States.

7 So, there is a special relationship, and I appreciate

8 that. So correct me if I am wrong, but this is

9 prospective, a permanent 5.25 percent corporate rate.

10 So, correct me if I am wrong, staff, but there would be a

11 certain big tax advantage for corporate headquarters.

12 Let me ask staff a question. Are we talking about

13 just manufacturing facilities? Could a corporation

14 maintain the facilities in the 50 continental U.S. States

15 and locate their headquarters in Puerto Rico and have the

16 5 percent tax under this proposal?

17 Mr. Yin. I believe it has to be relating to an

18 active trade or business in the possession. So, it would

19 apply to active trades or business in Puerto Rico, in

20 your example.

21 Senator Nickles. Wal-Mart could not have a post

22 office box, call it their headquarters, and change their

23 corporate rate from 35 percent to 5 percent?

24 Mr. Yin. I do not believe that is the intent here.

25 Senator Nickles. The scoring would not indicate

1 that they could either. I just wanted to point out the
2 difference between having basically a repatriation on
3 income that is already overseas that, frankly, if we do
4 not do anything will, in all likelihood, stay overseas,
5 as compared to prospectively having an incentive,
6 frankly, for people to locate in Puerto Rico. I just
7 wanted to make that point.
8 The Chairman. I am going to call on Senator
9 Bingaman. Then I am going to see, since this is not the
10 amendment that I thought that we could accept, if I can
11 talk Senator Breaux into something. [Laughter]
12 Senator Nickles. I know him well. He is always
13 amenable, Mr. Chairman.
14 The Chairman. Senator Bingaman?
15 Senator Bingaman. Mr. Chairman, I am sure I am
16 missing a lot of the fine points here. But I had thought
17 Senator Breaux made a very good point about the example
18 of the manufacturer in Louisiana having to pay a higher
19 tax rate and being at a disadvantage if that manufacturer
20 decided to employ people there in Louisiana.
21 I have the same concern about manufacturers in New
22 Mexico. Since I am here to represent New Mexico, I am
23 inclined to offer an amendment here that says anybody who
24 manufacturers in New Mexico should pay a 5.25 percent tax
25 on their income from that manufacturing activity. I do

1 not understand. What is the answer to the concern that
2 we are building in incentives for everyone to manufacture
3 everywhere but in the continental United States?
4 Senator Smith. Mr. Chairman?
5 The Chairman. Senator Smith?
6 Senator Smith. To Senator Bingaman's point, what I
7 would propose is retroactive. This is prospective. So
8 my question is to Pam Olson. If mine is not good policy
9 retroactively, one time, to bring capital into this
10 country to create some jobs, is this good tax policy to
11 do a 5.25 permanently for Puerto Rico? Because I have
12 got a frozen food company that is looking at Puerto Rico
13 now, if that is what you are telling me.
14 The Chairman. Secretary Olson?
15 Ms. Olson. Across-the-board cuts would be
16 preferable to targeted cuts. I think that this proposal
17 perhaps ought to be considered in the broader context of
18 looking at the taxation of Puerto Rico.
19 One of the concerns I would have with it is whether
20 it would actually encourage investment in Puerto Rico or
21 whether it would encourage repatriation from Puerto Rico.
22 The Chairman. All right. Are you done, Senator
23 Smith?
24 Senator Smith. Mr. Chairman, if it is not good tax
25 policy to do it retroactively, clearly it is not to go

1 prospectively. I think Senator Bingaman has a point.
2 All I am trying to do is help in an emergency in this
3 country right now where we need jobs to be created back
4 here and to bring that capital back. So, 5.25 sounds
5 pretty good.
6 But I think the other thing I would ask my colleagues
7 to remember, is that most of our competitors give their
8 foreign dollars a free walk back home. That is the world
9 our businesses operate in.
10 So if a German company can do BMWs in South Carolina
11 and take their money back to Germany with no tax, not
12 just 5.25, why is 5.25 so generous? This is the world
13 American business has to compete in.
14 I understand my friend's point from Louisiana. But I
15 also understand the macro world, I think, that American
16 businesses are penalized by because of our Tax Code. So,
17 a broader reform as to a territorial tax system probably
18 makes a lot of sense. But in the meantime, we ought to
19 do this much.
20 Senator Lincoln. Mr. Chairman?
21 Senator Bingaman. You are in favor of Senator
22 Breaux's amendment?
23 Senator Smith. I was referring to the retroactive
24 as opposed to the prospective.
25 Senator Bingaman. Oh.

1 The Chairman. Senator Lincoln. Then I want to see
2 if we can narrow this down and maybe get beyond this
3 point, because I hope Senator Breaux would be amenable to
4 a suggestion I have.
5 Senator Lincoln?
6 Senator Lincoln. Mr. Chairman, I have a question
7 about the first degree amendment that Senator Breaux has
8 to what is in the mark that Senator Smith has in there.
9 Is this an appropriate time to ask that?
10 The Chairman. No. Just a minute.
11 Senator Lincoln. All right. I will wait. I just
12 have a question.
13 The Chairman. Now, I think we all have to
14 appreciate that Puerto Rico has special problems. We
15 have tried to deal with those over a period of decades in
16 different ways, some of it through the tax policy. They
17 have been a very important issues before this committee,
18 and those tax policies have been on and off. That may be
19 part of the problem, I do not know.
20 But I am concerned about some aspects of your
21 proposal. I would be willing to consider an amendment
22 that Senator Kerry offered which would help Puerto Rico
23 by including their companies in a definition of domestic
24 manufacturer for the purpose of new domestic
25 manufacturing deduction in the bill. I would want to

1 discuss this a little bit with Senator Baucus, too.
2 Senator Baucus. Yes. Mr. Chairman, there are a lot
3 of competing Puerto Rico provisions here. I think the
4 best resolution at this point, because it is only fair,
5 that companies operating in Puerto Rico get the same
6 benefit, the same tax treatment as companies with respect
7 to the JOBS bill tax credit as companies operating within
8 the mainland United States, or Alaska or Hawaii.
9 At the same time, I think a study on this issue also
10 makes sense. I think that is going to be offered at some
11 point. But that, to me, is the best resolution, and
12 would proceed on that basis.
13 Senator Nickles. Mr. Chairman?
14 The Chairman. Senator Nickles?
15 Senator Nickles. Mr. Chairman, I want to make sure
16 I understand your counter proposal. I think your
17 proposal says, in the underlying bill you have
18 manufacturing taxed at 32 percent, and you are saying all
19 corporations in Puerto Rico would be taxed at that rate,
20 service or manufacturing, or just manufacturing?
21 Senator Baucus. Only manufacturing.
22 Senator Nickles. Only manufacturing.
23 Senator Baucus. We are just extending the
24 provisions of the bill to Puerto Rico.
25 Senator Nickles. All right. I understand.

1 Senator Baucus. To companies operating in Puerto
2 Rico.
3 Senator Nickles. I think that is a good
4 recommendation.
5 The Chairman. Senator Breaux, do you think you
6 would be amenable to what we have suggested? If you
7 would, then we would just accept the amendment.
8 Senator Breaux. I think it is 11 to 9, but I am
9 just not sure who has the 11 and who has the 9.
10 [Laughter]. I have got the number right. I just do not
11 have the ratio right.
12 I think it is interesting. We always get up to this
13 point where we all say we are going to do something for
14 Puerto Rico, and then we find some reason why we should
15 not do it on this bill, or that bill, or any bill. It
16 happens every time we get to this point.
17 Everybody says we ought to do something for the
18 citizens of the United States who happen to live in
19 Puerto Rico, who has twice the unemployment rate that we
20 have in this country, but we never take the next step.
21 We always put it off.
22 It is like the old Fram oil filter, "pay me now or
23 pay me later." We are going to be paying a lot more in
24 costs to Puerto Rico through unemployment and other
25 assistance that we are going to be providing, including

1 Medicaid, welfare, and everything else, unless we try to
2 do something that helps create jobs for its people, who
3 are citizens of the United States.
4 The point is, and as Senator Santorum said, we were
5 here before. We have been here. It has always been the
6 same reason. Everybody professes great willingness to
7 help Puerto Rico, but not here, not now, not today. The
8 question is, when?
9 I am appreciative of the fact that we would at least
10 do something for the citizens of the United States who
11 live in Puerto Rico, that we do involve other citizens of
12 the United States by making this bill applicable to them.
13 I think that sort of should be done, as an absolute
14 minimum.
15 I mean, I have heard from the Chairman and the
16 Ranking Member, and I do not want to push something
17 against both of their recommendations, and for that
18 purpose will withdraw the amendment.
19 Senator Nickles. Or accept the modification.
20 Senator Breaux. With the modification.
21 The Chairman. All right. We can adopt this
22 amendment, then move on to the Breaux amendment number
23 one.
24 Senator Santorum. Mr. Chairman?
25 The Chairman. Senator Santorum, proceed.

1 Senator Santorum. I would offer my amendment that
2 you were willing to accept that you thought was the
3 Breaux amendment.
4 The Chairman. Now, wait a minute. Let us take care
5 of this amendment.
6 Senator Santorum. All right.
7 The Chairman. Without objection, the modification
8 is agreed to. The Breaux amendment is adopted.
9 I think, before we go to your amendment, we should go
10 back.
11 Senator Santorum. I would just say, I think this is
12 the only other amendment on Puerto Rico. I would sort of
13 like to get that disposed with, since, just a few minutes
14 ago, sounded like you were willing to accept it. So, I
15 want to strike while the iron is hot here.
16 The Chairman. You want to get to lunch on time.
17 Proceed with your amendment.
18 Senator Santorum. This is a proposal which I think,
19 hopefully, you are willing to accept that would prevent
20 the double taxation of U.S.-source dividends distributed
21 by U.S. subsidiaries.
22 The Chairman. We want clarification. We want to
23 know which amendment you are offering here. Because if
24 it is one I am going to accept, I do not want to make the
25 same mistake I did on the Breaux amendment.

1 Senator Nickles. You got him all excited.
2 The Chairman. Yes.
3 Senator Santorum. It is my amendment number one,
4 which is amendment number 34.
5 The Chairman. Proceed to explain your amendment.
6 Senator Santorum. All right. This is for companies
7 that are organized in Puerto Rico that have subsidiaries
8 here in the United States.
9 They are subject to two levels of U.S. tax. First,
10 they pay a corporate tax of 35 percent, and then, when
11 they send the money back to Puerto Rico, they are subject
12 to a 30 percent withholding tax. So, they are doubly
13 taxed. We are going through a whole bunch of provisions
14 to try to eliminate that.
15 By the way, they are triply taxed, because if they
16 distribute dividends they are taxed again on dividends.
17 So, dividends are tripled taxed by Puerto Rican
18 corporations who have U.S. subsidiaries. I just believe
19 that that is excessive taxation.
20 Other U.S. territories are not subject to the 30
21 percent tax when those U.S. subsidiaries repatriate and
22 sends the money back to the U.S. territory, and we
23 believe that Puerto Rico should be similarly treated.
24 The Chairman. All right. While we are getting
25 analysis of your amendment, we will set it aside. We

1 will go to Senator Breaux's amendment.

2 Senator Lincoln, you have a question on the first
3 Breaux amendment. Then we will lay that aside so Senator
4 Smith could speak, I presume, in opposition to the Breaux
5 amendment.

6 Senator Lincoln?

7 Senator Lincoln. Thank you, Mr. Chairman.

8 I just want to make sure I understood Senator
9 Breaux's description of that amendment, where he said
10 that the overall amount that could be repatriated was
11 going to be capped.

12 If the parameters are in there to hopefully protect
13 where the dollars are going to be spent in terms of job
14 creation and others, why would you cap the overall amount
15 that a group could repatriate? Did I hear you correctly?

16 Senator Breaux. I do not know if you did. I think
17 everybody probably has a Breaux repatriation, a second-
18 degree amendment. It is really a first degree. The
19 deduction under the repatriation proposal would be
20 limited to only repatriations in excess of what they were
21 already repatriating.

22 I mean, the argument for this has been that they are
23 keeping the money over there and they are not bringing it
24 back here. Well, some of them are bringing it back.
25 Some of them are bringing some of it back.

1 So I am saying, look, let us figure out what they
2 were doing over the previous years and what they were not
3 bringing back, then that would be subject to the lower
4 tax rate because that would be the incentive to bringing
5 it back. If they were already bringing it back, there is
6 no reason to give them another incentive.
7 Mr. Yin, can you explain it a little bit more?
8 Mr. Yin. I am sorry, Senator. Could you repeat?
9 Senator Breaux. Repeat it? Where were you? I can
10 only say this one time.
11 Mr. Yin. Sorry.
12 Senator Nickles. Well, you explained it correctly.
13 Mr. Yin. Yes.
14 Senator Breaux. We are trying to say, if you want
15 to get the money back, you would have an incentive to do
16 it.
17 Mr. Yin. Yes. That is correct.
18 Senator Breaux. You try to say, all right, let us
19 make it apply to an amount over what you are already
20 bringing back.
21 Mr. Yin. Yes. There is a base period provision
22 that is in the underlying modification.
23 Senator Lincoln. So you are saying that the reason
24 that you are going to cap the overall amount is a
25 fairness issue.

1 Senator Breaux. Sure. Absolutely.
2 Senator Nickles. Basically saying you have to do it
3 over and above what you have been repatriating for the
4 past several years. Then there is another section. I do
5 not have a problem with that. I am a little skeptical of
6 trying to define what the money can be used for.
7 I do not like trying to micromanage other people's
8 money. You have some pretty broad categories that
9 included defined benefit plans, capital, research and
10 development, and so on that probably would fit for most
11 situations. But I was just a little skeptical of that.
12 Senator Breaux. Let me just summarize that, because
13 I know that Senator Smith will probably want to argue
14 against the whole thing. But I think everybody has said,
15 at least publicly, look, we want them to bring the money
16 back so we are going to give them a 5 percent tax rate if
17 they bring it back. If they bring it back, it is going
18 to do wonderful things.
19 I am just trying to tie it down to doing things that
20 are in the public interest, like research and
21 development, like hiring more wage earners, like using it
22 to fund their pension funds and their retirement plans,
23 or to expand through buying more equipment or capital
24 things that they need, but not to bring it back just to
25 sock it away or to repurchase stock in order to increase

1 the value of deferred compensation.

2 I mean, we are going to find out companies, if we do

3 not have some parameters, can bring the money back just

4 to give the CEO a huge stock option or make it more

5 valuable. That is not, certainly, what I think anybody

6 wants to do.

7 The Chairman. Senator Smith?

8 Senator Smith. Mr. Chairman, I am not sure, at

9 least as to the cap, that I am that far off from where

10 Senator Breaux is. What we are saying is, the reduced

11 rate applies only to repatriation in excess of the

12 taxpayers' average repatriation over three of the five

13 most recent taxable years.

14 Senator Breaux. Sounds like we are all right on

15 that.

16 Senator Smith. So there is a cap already. But

17 where I really get into trouble with some of the

18 limitations Senator Breaux puts on it, is I just do not

19 think we can micromanage what every corporate board

20 room's need is, as long as we are saying that it has to

21 be done for the purpose of job creation or job

22 preservation.

23 It is about jobs. A half a million jobs that could

24 come from this. So if you want to cut it back, limit it,

25 cap it more than that, then you are just limiting the

1 potential to create more jobs, that is all.

2 The Chairman. Did you want a roll call vote?

3 Senator Smith. I think so, yes.

4 Senator Nickles. Just a second. Your proposal is

5 in the bill, Senator Breaux's amendment.

6 Senator Smith. Yes.

7 Senator Nickles. All right.

8 The Chairman. I should ask Senator Breaux. You do

9 not want a roll call vote, do you?

10 Senator Breaux. If you accept my amendment, it is

11 not necessary.

12 The Chairman. All right. The question before us is

13 Breaux First degree amendment. Would the Clerk call the

14 roll, please?

15 The Clerk. Mr. Hatch?

16 The Chairman. No, by proxy.

17 The Clerk. Mr. Nickles?

18 Senator Nickles. No.

19 The Clerk. Mr. Lott?

20 Senator Lott. No.

21 The Clerk. Ms. Snowe?

22 Senator Snowe. No.

23 The Clerk. Mr. Kyl?

24 Senator Kyl. No.

25 The Clerk. Mr. Thomas?

1 The Chairman. No, by proxy.
2 The Clerk. Mr. Santorum?
3 Senator Santorum. No.
4 The Clerk. Mr. Frist?
5 The Chairman. No, by proxy.
6 The Clerk. Mr. Smith?
7 Senator Smith. No.
8 The Clerk. Mr. Bunning?
9 Senator Bunning. No.
10 The Clerk. Mr. Baucus?
11 Senator Rockefeller. Aye, by proxy.
12 The Clerk. Mr. Rockefeller?
13 Senator Rockefeller. Aye.
14 The Clerk. Mr. Daschle?
15 Senator Rockefeller. Aye, by proxy.
16 The Clerk. Mr. Breaux?
17 Senator Breaux. Aye.
18 The Clerk. Mr. Conrad?
19 Senator Rockefeller. Aye, by proxy.
20 The Clerk. Mr. Graham?
21 Senator Rockefeller. Aye, by proxy.
22 The Clerk. Mr. Jeffords?
23 Senator Rockefeller. Aye, by proxy.
24 The Clerk. Mr. Bingaman?
25 Senator Bingaman. Aye, by proxy.

1 The Clerk. Mr. Kerry?

2 Senator Rockefeller. Aye, by proxy.

3 The Clerk. Mrs. Lincoln?

4 Senator Lincoln. Aye.

5 The Clerk. Mr. Chairman?

6 The Chairman. No.

7 The Clerk. Mr. Chairman, the tally is 10 ayes, 11

8 nays.

9 The Chairman. The announced vote means that the

10 amendment has lost.

11 So, we now proceed back to Senator Santorum's

12 amendment.

13 Senator Lott. Mr. Chairman?

14 The Chairman. Could I finish his?

15 Senator Lott. Well, I just want to comment briefly,

16 and it will be briefly.

17 The Chairman. All right. Before we do that then, I

18 would like to have Mr. McClellan speak to a possible

19 compromise I think that we might have worked out on this

20 area, and then see if Senator Santorum could accept that.

21 Mr. McClellan?

22 Mr. McClellan. Thank you, Mr. Chairman.

23 Senator Santorum, when we generally reduce

24 withholding taxes in the United States vis-a-vis another

25 taxing jurisdiction, there is usually a parity. If we

1 reduce our 30 percent withholding on dividends down to 10
2 percent, they also agree to reduce their withholding on
3 dividends paid from that country to the United States by
4 an equal amount.
5 With respect to Puerto Rico, they impose a 10 percent
6 withholding rate on dividends to the United States. Our
7 normal protocols would be to match that withholding rate
8 on dividends paid from the United States to Puerto Rico.
9 I would suggest that, to maintain that parity, if we
10 were to reduce the withholding rate to a 10 percent rate
11 so that we match the rate that Puerto Rico imposes on
12 dividends paid to U.S. companies, it would be consistent
13 with other policy.
14 With respect to the other territories that you
15 mentioned, they have in the past maintained what is
16 called a "mirror code" that reflects the exact terms of
17 the United States.
18 A problem that occurred years ago was that, while we
19 had a 30 percent withholding rate, they automatically
20 picked that up and would impose a 30 percent withholding
21 tax in a territory against dividends paid to a U.S.
22 company. By mutual agreement, we wiped that out or
23 reduced that.
24 With respect to Puerto Rico, since they have not
25 reduced or eliminated withholding on dividends to the

1 U.S., we would suggest that there be a parity maintained
2 between the U.S. and Puerto Rican withholding rates, and
3 that we maintain that parity so long as their rate is 10
4 percent or less.
5 Senator Santorum. The intent of my amendment is to
6 do that. I just want to understand. You are saying that
7 if Puerto Rico goes down to zero, then our rate would go
8 down to zero.
9 Mr. McClellan. That would probably have to be
10 revisited by the committee. I was actually thinking the
11 inverse, that if we go down to 10 and theirs increases to
12 15, it would disrupt the parity.
13 Senator Santorum. Well, why can we not have it both
14 ways?
15 Mr. McClellan. I do not know if we can lower it
16 like that or if that requires legislative action. Again,
17 normally it requires----
18 Senator Santorum. Wait a minute. It does not
19 require legislative action to raise a tax but it does to
20 lower it? Is that what you are suggesting?
21 Mr. McClellan. In the past, when we have lowered
22 our tax rates, it has either been legislatively, as a
23 legislative decision at that point in time, or through
24 treaty negotiations. I am not aware of any other
25 legislation that automatically lowers it. I am just

1 talking about historical precedent.

2 Senator Santorum. But you are aware of a precedent
3 that automatically raises it?

4 Mr. McClellan. Usually, once we lower withholding,
5 do not raise it. That is primarily done, Senator, as a
6 treaty agreement.

7 Senator Santorum. You suggested, though, if Puerto
8 Rico raises it, then we would, by operation of this
9 language, you would suggest, raise it.

10 Mr. McClellan. Right. I would suggest that we
11 maintain parity. If it raises then we raise, and if they
12 lower then we lower.

13 Senator Santorum. All right. That is what I
14 suggested. So if they lower, we would lower. If they
15 raise, we would raise.

16 Mr. McClellan. That would be a suggestion. That is
17 fine.

18 The Chairman. All right. Senator Lott?

19 Senator Lott. Just briefly, Mr. Chairman. I do
20 support the Santorum amendment. This is about growth and
21 economic opportunity in Puerto Rico. We need to
22 encourage that. They are our commonwealth. We believe
23 that they are trying to make economic progress and this
24 will help in that effort. So, I support the amendment.

25 The Chairman. All right. Without objection, the

1 modified Santorum amendment is adopted.

2 The next amendment.

3 Senator Nickles. Mr. Chairman?

4 The Chairman. Senator Nickles?

5 Senator Nickles. Do you want to call it up?

6 The Chairman. Whose amendment is it?

7 Senator Nickles. Senator Kyl and I have an

8 amendment. Basically, Mr. Chairman, the essence of this

9 amendment--and correct me if I am wrong, staff--is the

10 Chairman's mark has a corporate rate for manufacturing at

11 32 percent.

12 Mr. Yin. That is correct. Once the deduction

13 phases in. Correct.

14 Senator Nickles. And it is phased in.

15 Mr. Yin. It is phased in gradually. The 9 percent

16 deduction which produces the approximately 32 percent

17 rate goes into effect, I believe it is, 2010.

18 Senator Nickles. Mr. Chairman, let me just say what

19 I want to do. I have been in the private sector and I

20 have been in manufacturing. I have also been in the

21 private sector and I have been in service. I really do

22 not like the inequality of saying this manufacturing

23 corporation pays a 35 percent rate and this corporation,

24 a service corporation or sales corporation, pays 35.

25 I believe, when the Chairman's mark is fully

1 implemented, that is the case. Is that correct? That
2 U.S. domestic manufacturing would pay 32 percent, U.S.
3 domestic sales, i.e., Wal-Mart or service companies,
4 corporations, would pay 35.
5 Mr. Yin. Yes. The Senator is correct.
6 Senator Nickles. Mr. Chairman, Senator Kyl and I--
7 and I will let him speak for himself--believe there are
8 different ways of doing this, but frankly we would like
9 to have one corporate rate.
10 Some corporations do service, do sales, and do
11 manufacturing. I can see a lot of confusion. I see a
12 lot of inequities. Why should one company have a 10
13 percent lower corporate rather than another?
14 I understand manufacturing has had difficult times.
15 I came from manufacturing, Nickles Machine Corporation.
16 We made parts. We are manufacturing. I am arguing
17 against my own parochial interest. But I happen to think
18 it is a lot better tax policy to have a unified corporate
19 rate for all corporations, not something special for
20 manufacturing.
21 So the essence of the amendment would be to have
22 basically the equivalent amount of money be spread out
23 for a lower, unified rate. We have looked at some
24 figures. I think there is ample money to reduce it from
25 35 to 34, maybe 33.5. Is that correct?

1 Mr. Yin. That is correct, Senator. There are a
2 number of possibilities, but there would be a way, with
3 the amount of revenue that is being raised in this bill,
4 to provide for a 33 percent rate sometime in the budget
5 window.
6 Senator Nickles. For all corporations.
7 Mr. Yin. For all corporations. Correct.
8 Senator Nickles. Well, Mr. Chairman, that would be
9 our amendment. We propose to file it a couple of ways,
10 where actually we would to 32 percent for five years and
11 then sunset it. I am not sure that is my preference. I
12 would like to have a lower flat rate for all
13 corporations.
14 If 32 percent is the figure, I would hope that we
15 would modify the Chairman's mark and make that applicable
16 for all U.S. domestic corporations, all U.S. corporations
17 would be at 33 percent.
18 Mr. Yin. Thirty-three percent.
19 Senator Nickles. Thirty-three percent, instead of
20 having a dual system of 35 percent for service and sales
21 and 32 percent for manufacturing.
22 The Chairman. Senator Kyl?
23 Senator Kyl. Thank you, Mr. Chairman. As Senator
24 Nickles said, there are at least three basic ways of
25 doing this. If you are going to get the most bang for

1 the buck, then you would want to have the rate reduction
2 occur immediately. But the cost element of that would,
3 under our proposal number two, bring it into effect
4 immediately for the years 2004 through 2008, but it would
5 not go beyond that time.
6 Perhaps more sensible for the long term, although it
7 would not have quite as much immediate impact, would be
8 the phase-in, where you would have the 34 percent rate
9 for the years 2004 to 2006, and then 33 percent for the
10 years 2007 to 2008, and then 32 percent for the years
11 2009 and 2010.
12 Both of those are within the income window that we
13 have here. That one is estimated at about $95 billion
14 from 2004 to 2010. The other one is about the same,
15 about $95 billion.
16 Mr. Yin. Senator Kyl?
17 Senator Kyl. Yes?
18 Mr. Yin. The intermediate period goes down in stair
19 steps so that it would first go down to 34.5, 34, 33.5,
20 and ultimately it does get to 33. That is correct.
21 Senator Kyl. Well, actually, the version I was just
22 describing actually gets to 32.
23 Mr. Yin. All right.
24 Senator Kyl. And it goes down a percent at a time.
25 I indicated there are about three major ways of doing it.

1 The other way is to go to the 33 percent rate, as Senator
2 Nickles pointed out, and you can do that for the longer
3 period of time and would not have to have as long of a
4 phase-in period.
5 We wanted to raise this, not to just have one version
6 that we would put down, but because we think there is
7 substantial support for this. It is very wrong for us,
8 just on today's circumstances, to favor one part of
9 industry, one part of business, over another. That is
10 bad tax policy. We do not do that as an ordinary
11 proposition.
12 We are all supportive of the reduction in tax for
13 manufacturing. But obviously, for fairness purposes and
14 to accommodate the usual goals of our Tax Code, we would
15 not have that kind of discrimination built in. This
16 proposal meets all three of the normal tax goals.
17 It is neutral, obviously, as I have described. It is
18 fair, in that it retains the equitable distribution of
19 the tax burden, not favoring one type of company over
20 another. And it is efficient, because it does not
21 require the government to calculate or administer
22 different kinds of systems, or encourage gaming.
23 So this concept, in any one of those three
24 iterations, I think, would be preferable to what we have.
25 Rather than just try to impose one or the other, our

1 thought was to initiate the discussion and see if a
2 consensus could develop around one of these general
3 concepts and adopt that.
4 Senator Kyl. Thank you, Mr. Chairman.
5 Senator Breaux. Mr. Chairman?
6 Senator Lincoln. Mr. Chairman?
7 The Chairman. Senator Breaux, then Senator Lincoln.
8 Senator Breaux. So, as I understand it, this is
9 just a cut in the corporate rate from 35 to 32 for
10 everybody?
11 Senator Nickles. From 35 to 33.
12 Senator Breaux. To 33 for everybody.
13 Senator Nickles. From 35 to 32, is the proposal
14 that I am advocating, basically trying to take the money,
15 and instead of saying we are going to give manufacturing
16 32 percent, other corporations 35 percent, making it
17 uniform for all corporations, which it is today, I might
18 add, and so trying to reduce the rate for all
19 corporations, not just manufacturing. But the rate
20 reduction would only be down to 33 percent instead of 32
21 percent for manufacturing.
22 Senator Breaux. All right. My concern is, as I
23 understand what we are trying to do, is to address the
24 problem of the export subsidies for manufacturers--not
25 for all corporations, but for manufacturers who export

1 overseas. But the subsidies we are giving them were
2 illegal under the GATT and under the WTO.
3 So we said, all right, we are going to eliminate that
4 subsidy and that is a penalty to manufacturers who
5 export. So we said, all right, we are going to take the
6 money that we raise from eliminating this subsidy and
7 give it to the people we took it away from, the
8 manufacturers.
9 This amendment was going to say, no, we are going to
10 take the money and give it to anybody who is a
11 corporation, regardless of whether they were getting a
12 subsidy for exporting overseas or not.
13 We have got a $500 trillion deficit and we are just
14 going to cut revenues? I mean, I do not understand that.
15 I think there was a connection between manufacturers who
16 exported who got a subsidy.
17 We are taking away the subsidy, so we are trying to
18 help them domestically. If I was a manufacturer who lost
19 the subsidy, I would say, wait a minute, you are taking
20 it away from me and giving it to everybody else. I do
21 not think that is right.
22 The Chairman. Senator Breaux, you are absolutely
23 right.
24 Senator Breaux. Oh, good. [Laughter]
25 The Chairman. I have got to reflect why we are

1 here. We are here because of the WTO ruling. The WTO
2 ruling, contrary to our interests, negates the purpose of
3 the Foreign Sales Corporation legislation in the first
4 place, which was to put American manufacturing on par
5 with the Europeans, because they had the Value Added Tax,
6 which does not export, and we export our taxes.
7 So the reality is, we have been helping this class of
8 corporations to maintain jobs and to have parity over a
9 long, long period of time. Now, WTO screws it up for us,
10 so we respond to that.
11 So what we are trying to do here, is to continue to
12 help our manufacturers and give some parity. And maybe
13 we are broadening it somewhat in the process because of a
14 terrible economic downturn in manufacturing since March
15 of 2000, which is hopefully just now turning around.
16 That is what this legislation does. So the Senator's
17 amendment is well intended. When I say it is simple,
18 that is not to denigrate it, because the simpler tax
19 legislation is, the better. It would also probably be a
20 stimulus.
21 But these rate cuts that would be suggested would not
22 distribute evenly to those taxpayers who are losing
23 FSC/ETI, where we have had a problem of a level playing
24 field for our manufacturers with competition overseas for
25 a long period of time. So, I think that that is why it

1 should be rejected.

2 Senator Lincoln?

3 Senator Baucus. Mr. Chairman?

4 Senator Lincoln. Thank you, Mr. Chairman.

5 The Chairman. Then Senator Baucus.

6 Senator Lincoln. The percentage of those that are

7 actually--you mentioned service.

8 Senator Nickles. Yes.

9 Senator Lincoln. But most services are not

10 structured as a corporation, are they?

11 Senator Nickles. Well, you have both. Sure, you

12 have a lot of service corporations. There is a lot of

13 the corporate world out there that, right now, is going

14 to be saying, we are going to have to design our company

15 to be classified as a manufacturer.

16 Just to give you an example, what is Oracle or Intel?

17 Intel has manufacturing, but Oracle is software. Or Wal-

18 Mart is sales. Now, should Wal-Mart be paying a higher

19 tax rate than Nickles Machine Corporation? We are living

20 in the same community, we are generating income. I am a

21 manufacturer, but I am competing with Wal-Mart. Should I

22 have a 10 percent lower corporate rate? Maybe I should

23 say thank you very much.

24 I would also like, Mr. Chairman, to ask the

25 administration if they have a position on this issue.

1 Senator Lincoln. Do we know how much it costs?
2 Senator Nickles. We are making it revenue neutral.
3 We are basically saying, take the FSC money that we have
4 in this pool, and instead of having different rates, let
5 us have uniform rates.
6 Senator Lincoln. All right.
7 The Chairman. Secretary Olson, do you want to
8 respond to what Senator Nickles asked?
9 Ms. Olson. Thank you, Mr. Chairman. We have a lot
10 of concerns about this provision as well, for the reasons
11 that Senator Nickles and Senator Kyl have articulated.
12 The provision, I think, is going to be very difficult
13 administratively to administer for the IRS. I think it
14 is going to be very difficult for taxpayers to comply
15 with as well. There are definitional issues. There are
16 computational issues. I think it is going to increase
17 the regulatory burden on businesses and that is going to
18 create compliance problems.
19 I am not sure, quite frankly, that some of the
20 smaller businesses that are being swept up in this that
21 are not currently covered by FSC and ETI are even going
22 to be able to use it because of the complexity of the
23 provisions.
24 It does favor one sector over another, which will
25 have the effect of distorting investment decisions. In

1 many ways, because, for example, of the haircut, you are
2 going to be disproportionately removing the benefit from
3 the current beneficiaries of FSC/ETI because they do tend
4 to be multinational corporations who are going to lose
5 some of the benefit under the haircut provision.
6 There was a similar provision in Canadian law.
7 Canada has recently repealed its similar provision in
8 favor of across-the-board rate cuts, along the lines of
9 what Senator Nickles and Senator Kyl have proposed.
10 The reasons for them repealing their provisions were
11 the administrative difficulties, as well as the fact that
12 they came to believe that it would cause economic harm to
13 other sectors of the economy besides manufacturing.
14 Senator Nickles. Mr. Chairman, could I ask an
15 additional question of Ms. Olson?
16 The Chairman. Yes. Go ahead.
17 Senator Nickles. I am just wondering. If you are
18 multinational and you happen to be in all three, you are
19 a big company and you have financial services, you have
20 retail sales, and you have manufacturing, would that not
21 be very difficult for that company to allocate which is
22 which?
23 I mean, I could see a nightmare. Do you take the
24 corporate headquarters and say that portion is
25 manufacturing? I would guess, if we kept the 10 percent

1 lower rate for manufacturing, you would see a greater
2 number of manufacturing jobs all of a sudden appearing,
3 although they might really be a lot more like sales jobs.
4 I mean, I can see a lot of games, Mr. Chairman. I
5 know you are well intended. I just think that this is a
6 mistake. I was not aware of the fact that Canada had
7 repealed it.
8 But a uniform, simple corporate rate, to me, for this
9 3 percent difference, when you have companies doing all
10 three things--my question to you is, would that not be a
11 real mess for a multinational if it does all three?
12 Ms. Olson. There will be significant expense
13 allocation issues. I would note that some of those
14 expense allocation issues also arise in the context of
15 FSC and ETI. Eighteen years after we enacted FSC, we are
16 still litigating some of those issues in court.
17 The Chairman. It is ludicrous that you take the
18 position that we are favoring one over another. What do
19 you think FSC has been doing for three decades? And what
20 do you think that the administration did on steel when
21 they put 30 percent tariffs on? Particularly, we lost
22 more jobs in my State because of not being able to import
23 steel than the benefits that come from the 30 percent
24 tariff.
25 Senator Bingaman?

1 Senator Bingaman. Mr. Chairman, along the same
2 lines. Is the administration's position that they would
3 want us to replace FSC/ETI with something that Senator
4 Nickles and Senator Kyl are now proposing?
5 Ms. Olson. Senator Bingaman, I think that it would
6 be a much more administrable set of rules to do something
7 across the board rather than something specific. I
8 previously before this committee talked about the fact
9 that there are provisions in the Code that
10 disproportionately adversely affect manufacturers,
11 things, for example, like certain provisions in the AMT.
12 We could strike a real blow for simplification by
13 addressing some of those issues with the revenues that
14 would come from repealing FSC and ETI.
15 Senator Bingaman. So you are saying that we should
16 do what they are suggesting, plus deal with AMT? And we
17 have got enough money from----
18 Ms. Olson. No, I am not saying we have enough
19 money. We have to make choices. We clearly have to make
20 choices.
21 Senator Bingaman. What is your choice?
22 Ms. Olson. My choice would be to strike a blow for
23 simplification and address some of the provisions in the
24 Code that have disproportionately adversely affected
25 manufacturers.

1 Senator Bingaman. So, rather than doing what
2 Senator Nickles and Senator Kyl are proposing, you think
3 we should take this money and go after this AMT and other
4 provisions which particularly adversely affect
5 manufacturers.
6 Ms. Olson. I think that would be a good use of the
7 money, yes.
8 Senator Bingaman. Do we have any kind of proposal
9 from the administration that would accomplish that?
10 Ms. Olson. Well, there are a couple of provisions
11 in the administration's budget that would address some of
12 the disadvantages. For example, the Section 179
13 expending provision, the R&E credit.
14 There are some things that we could look at that we
15 do not have a proposal yet, but we are currently looking
16 at with respect to the R&E that would make it more usable
17 by manufacturing companies.
18 Senator Bingaman. Well, at least from my
19 perspective, and sort of in defense of Chairman Grassley
20 and the Ranking Member, Senator Baucus, I think they felt
21 there was a real time pressure to come up with some kind
22 of alternative in light of the problem we have run into
23 with FSC ETI.
24 I would be anxious, frankly, to see any kind of
25 proposal the administration had as a way to use this

1 funding and still assist manufacturers, but I have not
2 seen it.
3 Also, let me just ask Senator Nickles. One of the
4 provisions that the Chairman and Ranking Member put in
5 this mark that I greatly appreciated was that they made
6 it applicable to sole proprietorships and partnerships in
7 addition to just corporations.
8 Frankly, in my State a lot of the manufacturing that
9 is done--and we do not do much, but that that we do--is
10 done by partnerships or sole proprietorships. Are you
11 suggesting that this money be used just for corporations
12 in your amendment, or are you also trying to provide the
13 tax break to partnerships and sole proprietorships?
14 The Chairman. He is trying to do it just for
15 corporations and reinstitute a penalty against small
16 business that we took out in the tax bill in June.
17 Senator Nickles. Is that what I was doing?
18 [Laughter]. Well, I am really glad you clarified that
19 for me. You can read my mind better than I could. I
20 might not have had an answer for his question, but I am
21 glad that you could speak for me so quickly.
22 The Chairman. Senator Kyl?
23 Senator Kyl. Well, I think Senator Santorum wanted
24 to speak, and I will just take a second here. The
25 specific provision, to answer your question, only applies

1 to the corporate rate.

2 But, of course, the idea of reducing the corporate

3 rate is because the corporate tax, in effect, is a double

4 tax, whereas, with regard to the personal income tax of

5 the partnership, for example, you have a single tax

6 because of the pass-through effect.

7 So, you do not have the same incentive, I think, to

8 reduce the personal tax here that would apply to the

9 partnership, for example, that you do for the corporate

10 income tax rate.

11 The Chairman. Senator Santorum?

12 Senator Santorum. Thank you, Mr. Chairman. Mr.

13 Chairman, I am going to support you and the Ranking

14 Member in your mark because I, too, believe that this is

15 money that is now devoted to help manufacturers be

16 competitive, and that we need to do something to continue

17 to do that.

18 As far as the specific provisions, I, too, am

19 concerned about some of the complexity issues that have

20 been surfaced here today by Senator Nickles, Senator Kyl,

21 and the administration. I would certainly be open to

22 other avenues by which we could support manufacturing,

23 whether it is through this approach or other approaches.

24 I think it is important to lay down a mark that this

25 money is now dedicated for manufacturing, and should

1 continue to be dedicated to manufacturing. I am not
2 wedded a this point to any particular model on how we
3 accomplish that.
4 You have put forward something that is a reasonable
5 proposal. I suspect that, through the process, this will
6 be worked on and we are going to have to shape it in
7 response to some of the criticisms that have been
8 leveled. Some of them, I think, are legitimate.
9 Some manufacturers in my State have come forward and
10 said, gee, if you could do something to help us with some
11 of our legacy costs, for example, and give us an
12 opportunity to deal with that as an alternative to this,
13 not make us eligible for this, but make us eligible for
14 some other kind of help that may more specifically affect
15 us as an old manufacturer.
16 Again, I am not trying to call into question what the
17 committee has done. I think they have made a good faith
18 effort to focus this money on a sector of the economy
19 that is not competing with Wal-Mart. I take issue with
20 Senator Nickles, who says, my tool and machine factory is
21 competing with Wal-Mart. No, you are not. They are
22 competing with the Chinese and with a whole bunch of
23 other foreign competitors. That is who we need to help
24 advantage. They are not competing with the local retail.
25 They are competing with people who are trying to

1 import into this country who are getting huge subsidies
2 and who are getting the benefit of a lot of other games
3 that their governments play. We have to try to compete
4 with that, and that is what this mark does, and that is
5 why I am supportive.
6 Senator Nickles. Mr. Chairman?
7 Senator Baucus. Mr. Chairman?
8 The Chairman. Senator Baucus? He wanted to speak
9 against your amendment, first.
10 Senator Nickles. All right.
11 Senator Baucus. Mr. Chairman, I think you know the
12 drift of the result here. An analogy here is, what if we
13 have a provision here to help, correctly, appropriately,
14 say, an industry. Let us say it is real estate, or a
15 mine or something. So, we work on this amendment.
16 Somebody comes up with a substitute and says, lower
17 the corporate rate for all corporations because that
18 helps that industry. It turns out, it helps every other
19 corporation, every other industry, too.
20 That is, in effect, what this amendment does. The
21 ETI provision was a manufacturing provision. The
22 replacement should be a manufacturing replacement. It
23 should not be a replacement that deals with
24 manufacturing, but also other sectors of the economy as
25 well, which this amendment does. Add to that, frankly, a

1 lot of companies are quite concerned about the FSC/ETI
2 phase-out, as to how long should the phase-out period be?
3 The effect of this amendment is immediate, and that
4 is going to put a lot of companies in a big world of
5 hurt, frankly. That is probably an unintended
6 consequence of this amendment. But my sense is that the
7 amendment is not going to prevail, and it should not
8 prevail for the reasons that I and other Senators have
9 mentioned.
10 The Chairman. Senator Nickles, then Senator Kyl.
11 Senator Nickles. Mr. Chairman, two or three
12 comments. This is basically the thickness of what we are
13 getting ready to pass. Having a different corporate tax
14 rate for manufacturers than other corporations is a
15 serious mistake if you believe in tax simplicity.
16 We will rue the day if we make this law. This may be
17 the best thing for creating manufacturing jobs that you
18 could ever do, because you will see a lot of companies
19 growing into a manufacturing definition so they can get a
20 lower rate.
21 It does give a lower rate for manufacturing than it
22 does to other corporations. They will be sitting side by
23 side in Little Rock and in Oklahoma City. One is going
24 to be a corporation that manufacturers something, one is
25 going to be a corporation that does not, and one is going

1 to pay a 10 percent higher tax.

2 They may or may not export. Exports are not part of

3 this equation. This is a lower rate for manufacturers.

4 So this idea of, well, we are trying to replace the

5 subsidies, well, that does not fly, frankly.

6 You want to have a different corporate rate for

7 manufacturing. I think that is a mistake. I think the

8 definition of manufacturing is going to grow

9 dramatically. I do not think that is good tax policy and

10 I think we will regret it.

11 I, at this point, will defer to my colleague, Senator

12 Kyl. But it is not my intention to push this amendment

13 in the committee. It is my intention to consider pushing

14 it on the floor of the Senate.

15 I would urge my colleagues to try to ask their

16 constituents, including those that would benefit from the

17 lower manufacturing rate, if they think it makes sense to

18 have these dual rates for corporations.

19 Senator Snowe. Mr. Chairman?

20 The Chairman. First of all, Senator Kyl. Then I

21 will call on you.

22 Senator Kyl. Thank you. Yes. Let me do the second

23 half of withdrawing the proposal. I wish Phil Gramm were

24 still with us, because he could think of a more humorous

25 way to say what I am about to say that might be accepted

1 with a little more feeling of goodwill.
2 But I must say, when I sought to come on the Finance
3 Committee, one of the reasons was because of the
4 reputation of this committee as not only a relatively
5 bipartisan committee, but one of the most serious
6 committees in terms of tradition in the Senate, charged
7 with the very difficult responsibility of ensuring fair
8 taxation and a sensible Tax Code in this country.
9 The three tax policies that are articulated, I did
10 not make up. These have guided the committee for years.
11 The point that Senator Nickles is making is one I think
12 we have to very seriously consider.
13 So for those of you who are wanting to help
14 manufacturers, think about this, too. We have an
15 obligation to write a Tax Code that will stand the test
16 of time, represents fairness and equality for our
17 taxpayers, as well as produce revenue and help certain
18 industries.
19 We should write a Tax Code that does not discriminate
20 between two different businesses that are essentially in
21 the same class, and up to now have always been in the
22 same class in terms of tax rate.
23 We have provided some subsidies in the form of
24 certain credits and deductions and so on as part of our
25 Tax Code. Apparently, having done that for

1 manufacturing, we are now saying it is only fair to
2 continue that subsidy, but now we have to do it in the
3 form of a differential tax rate. That is where we make
4 our fundamental mistake.
5 What I propose to do is work with the administration
6 before the bill comes to the floor to see if we can take
7 advantage of the opportunity here to deal with the very
8 specific problem for manufacturing that has been pointed
9 out, and perhaps we can, through a combination of lower
10 the tax rate for manufacturers, as well as others, and
11 dealing with these other problems that relate
12 specifically to manufacturers, we can achieve both
13 objectives in helping our manufacturing sector, but not
14 doing so at the expense of similar businesses.
15 The Chairman. Or we can also impose a $50 billion
16 tax on a segment of manufacturing as well.
17 Senator Snowe?
18 Senator Snowe. Thank you, Mr. Chairman. I want to
19 applaud you for the approach that you have taken in the
20 underlying legislation. I do think it is the appropriate
21 focus and target to address the manufacturing sector of
22 our economy. I think it is nice to deal with theories or
23 reality.
24 The reality is, the manufacturing sector of our
25 economy is losing jobs at an alarming rate. We have lost

1 more than 2 million, almost 3 million jobs over the last
2 three years, and they are all manufacturing jobs.
3 In my State alone, over the last three years we have
4 lost close to 18,000 manufacturing jobs, the second
5 highest percentage in the country. It is across the
6 board in America. It will not be a question of
7 discriminating among corporations, I can assure you.
8 There will not be anything to discriminate against.
9 We will not have a manufacturing segment in our economy.
10 It affects a lot of enterprises, all the sub-businesses
11 that depend on manufacturing. It has a broad impact
12 across our entire economy.
13 So I think that we in the Congress, we here in the
14 committee that have the ability to target our policy,
15 most appropriately, would be focusing on the
16 manufacturing segment in this legislation, because 95
17 percent of all of the manufacturers use the FSC/ETI.
18 That is a fact.
19 So, I think we do have an obligation to see what we
20 can do to improve the conditions in America so that
21 manufacturers can survive. That is what we are talking
22 about, total survival.
23 It is not a question that they represent a broad
24 segment of our economy. We are lucky we have 8 percent
25 representative of our entire economy that you could say

1 constitutes manufacturers.

2 It is a service economy, and that is all well and

3 good. But what has happened? Our trade policies have

4 accelerated this erosion and it is an erosion that is

5 occurring at an alarming rate.

6 So while we can sit here and talk about theories, I

7 would suggest we look at reality. The reality is, we are

8 losing these jobs. These are the people that we

9 represent. They are losing quality, paying, decent jobs

10 that will never come back unless we do something to

11 restore it.

12 So,

13 what the Chairman has done is most appropriate, focusing

14 on that segment that disproportionately will be affected

15 by the repeal of this tax.

16 The Chairman. Thank you very much.

17 We have all of our amendments taken care of, so I

18 want to move to report the bill.

19 Senator Snowe. Mr. Chairman?

20 Senator Bunning. Mr. Chairman? I have an amendment

21 that I would like to offer.

22 The Chairman. I am sorry. The Senator from

23 Kentucky.

24 Senator Bunning. I must have missed it. I was gone

25 15 minutes. Did you do a lot of amendments in those 15

1 minutes?

2 The Chairman. Yes, we did do a few amendments.

3 Yes.

4 Senator Bunning. All right. Thank you.

5 I have an amendment I would like to offer. It is

6 Bunning amendment number one.

7 The Chairman. I can accept it.

8 Senator Bunning. Accept it?

9 Senator Baucus. Whoa. Whoa. Whoa. Whoa. Whoa.

10 Senator Bunning. Next amendment.

11 Senator Baucus. What is amendment number one?

12 Senator Bunning. Bunning amendment number one would

13 end the unfair treatment of the taxation of horses. It

14 takes it from a two-year cycle, which no other capital

15 asset does. No other capital asset.

16 Under present law, gains from virtually every capital

17 asset, except horses, qualifies for capital gains

18 treatment once it has been held for one year. The

19 holding period for horses is two years. Two. I think

20 that is unfair.

21 I lost that amendment by one vote in the Ways and

22 Means Committee nine years ago. Nine years ago. There

23 is no reason to treat horses differently from any other

24 capital asset.

25 The horse industry provides sports, recreation and

1 entertainment for millions. This industry has an
2 economic impact on the United States' economy of $112
3 billion and supports 1.4 million jobs. It pays out $1.9
4 billion in taxes at all levels of government.
5 This provision was apparently put in in 1969 as an
6 anti-tax shelter provision. Since then, there have been
7 numerous changes in the tax laws, and particularly the
8 passive loss limitations which have virtually eliminated
9 all so-called tax shelters.
10 This tax provision has discriminated against
11 Kentuckians, New York residents, Californians,
12 Floridians, people from Maryland, and many other places
13 where horses are a main portion of the industry. That is
14 too long. Whatever the rationale was for making the
15 holding period for horses different, it has outlived its
16 usefulness.
17 Senator Baucus. What is the holding period for
18 cattle?
19 Senator Bunning. The same as horses.
20 Senator Baucus. So would you change it?
21 Senator Bunning. I would be more than happy to
22 include cattle in the amendment.
23 Senator Baucus. What about other livestock?
24 Senator Bunning. Other livestock only has a one-
25 year provision.

1 Senator Baucus. Mr. Chairman? I do not know if we
2 want to do this at this point. I have the highest regard
3 for the Senator from Kentucky and I understand the
4 arguments. It is my understanding that this was
5 amendment was not going to be offered, and it therefore
6 was not studied by Senators. But here it is.
7 So my suggestion is that, frankly, the Senator
8 withdraw and we work this out somehow. I want to make
9 sure we know what we are doing here before we adopt the
10 amendment. As I mentioned in my questions, there are
11 other livestock that may deserve similar treatment.
12 Senator Bunning. Just cattle.
13 Senator Baucus. Let us figure out what we are doing
14 here first before we act.
15 Senator Bunning. Well, I have been figuring it out
16 for 10 years.
17 Senator Baucus. Well, you may have, Senator. I
18 appreciate that and I commend you for it. But other
19 Senators here have not. It was my understanding that
20 this amendment was not going to be offered, so we have
21 not had the opportunity to try to figure out to know what
22 is the best way to handle all this.
23 So, anyway, I very strongly suggest, Senator, I hear
24 you. We have horses, too, in Montana. In fact, we have
25 some pretty good racehorses in our State. In fact, one

1 came in second in the Kentucky Derby, a Montana horse.
2 So, I would urge us, frankly, to see what we can work out
3 by the time we get to the floor. I will work with the
4 Senator.
5 Senator Bunning. I will work with you to do that,
6 and withdraw the amendment.
7 The Chairman. Thank you. Thank you very much.
8 Senator Snowe. Mr. Chairman?
9 The Chairman. The Senator from Maine.
10 Senator Snowe. Thank you, Mr. Chairman.
11 As you know, I filed an amendment regarding how ship
12 builders report their income and allocate their costs.
13 Obviously, it is an issue of fairness. I would like to
14 work with you before we go to the floor on this issue,
15 because I understand you have some concerns about the way
16 in which I am addressing it in my amendment.
17 But I would like to work through it with you before
18 we go to the floor, because it really is an important
19 issue that will continue to enhance the viability of the
20 ship building industry with their foreign competitors and
21 all of the sub-industrial base that also depends on ship
22 building.
23 So, I would hope that we could work on this towards a
24 viable solution that would enhance the condition and the
25 industry as a whole.

1 The Chairman. Well, I know that this is a very
2 important issue for you and your State. We are reluctant
3 to reopen the completed contract method of accounting.
4 It was an ordeal for the committee during the 1986 Tax
5 Reform Act.
6 Senator Baucus. It sure was.
7 The Chairman. I would be glad to work with you and
8 look at modifications to the percentage of completion
9 method or other current accounting issues that are
10 applicable to Navy ship building.
11 Senator Snowe. I appreciate that, Mr. Chairman.
12 Senator Baucus. I might say, this was the issue
13 that held up that 1986 bill, and finally got resolved.
14 The issue.
15 Senator Snowe. I understand what occurred, because
16 I was in the House at that point in time. I think there
17 are some real unique issues that affect the way in which
18 they build these ships over a period of time.
19 My approach was, obviously, to have them pay taxes on
20 the profits at the time of delivery, which I think is a
21 different situation. But I am willing to look at various
22 other options in the process. Thank you.
23 The Chairman. Senator Breaux?
24 Senator Breaux. Is everybody going somewhere? Is
25 the Chairman's desire to continue the mark-up? What are

1 we doing? I have got another amendment.

2 Senator Nickles. You have already had one.

3 Senator Breaux. I have got another one.

4 The Chairman. If the Senator desires to offer an

5 amendment, we are going to honor that request. But I do

6 want to move on. I am hoping to have 11 people here and

7 vote this bill out today.

8 Senator Breaux. That was what I was thinking, but

9 you all were leaving.

10 The Chairman. All right.

11 Senator Breaux. Mr. Chairman, I have an amendment

12 with Senator Lott on what is commonly referred to as

13 subpart F shipping income. We had a lot of discussions

14 about companies that have overseas operations, how they

15 are not taxed if the money remains overseas.

16 The repatriation amendment of Senator Smith would

17 say, all right, if you have that money you can bring it

18 back over here, and we are only going to let you pay a 5

19 percent tax on it.

20 In the shipping industry, it is totally different. A

21 U.S. company which has overseas operations in the

22 shipping business that owns vessels, the money they own

23 overseas, whether they take it back to the United States

24 or not, is taxed. If the money stays overseas, never

25 comes back to the U.S. shore, the U.S. company has to pay

1 income tax as if the money had been brought back over
2 here.
3 So, Mr. Chairman, we had sent this to Joint Tax for a
4 score to see, if we simply said they do not pay tax on
5 overseas income if it stays overseas. Everybody else is
6 treated like that. This was a revenue raiser back in
7 1986.
8 For the life of me, it seems that this is the only
9 industry that is taxed on overseas earnings, even if they
10 are not repatriated back to the United States. We had
11 sent this over, Mr. Yin, and I was wondering if we had a
12 score on this. How much would it cost? If it is more
13 than the industry earns, I am going to be really
14 surprised.
15 Mr. Yin. Senator, we have a very tentative score.
16 It depends on the effective date. For tax years
17 beginning after 2004, our score would be $2.7 billion
18 over the 10 years.
19 Senator Breaux. Which is probably more than the
20 industry earns, which makes me suspect that the score may
21 not be correct. The industry does not make $2.7 billion,
22 and yet you are telling me that, by not taxing them on
23 the income, we are going to lose more than the income
24 than the industry makes. You said it is a tentative
25 score. That means questionable?

1 Mr. Yin. No. It simply means that this is our very
2 preliminary score based on the data and the analysis that
3 we have been able to do up to this point.
4 Senator Lott. Senator Breaux, if you would yield.
5 Earlier, it had been indicated to us that it was $100
6 million. Then we were shocked to hear that Joint Tax
7 said it might be $2.8 billion. There is a big difference
8 there. Maybe it has to do with effective dates.
9 Mr. Yin. That is a possibility. I am not familiar
10 with the $100 million score, Senator.
11 Senator Lott. Well, I do want to support the
12 amendment. There is no question this puts U.S.-owned
13 companies at a distinct disadvantage. It is causing us
14 to just lose our U.S. merchant fleet. We need to do
15 something about it. This really has major consequences,
16 and that is why I do support the amendment.
17 Senator Breaux. Well, perhaps I would confer with
18 Senator Lott. I mean, since we do not have a score, that
19 score cannot be accurate if you look at the entire
20 earnings of this industry, perhaps we should wait until
21 we get a better read on how much it is estimated to cost,
22 and we will come back and revisit it on the floor.
23 The Chairman. If you would do that. Because I
24 think, otherwise, you have a problem of your not having
25 an offset as part of your amendment that would make it

1 out of order.

2 Senator Baucus. I might add, Mr. Chairman.

3 The Chairman. Go ahead.

4 Senator Baucus. There is a reason why shipping

5 income is subpart F income. It is harder to pin down.

6 Where is the cargo loaded? Where is it unloaded? Which

7 jurisdiction, what area, and so forth, and so forth? I

8 understand the Senator's point. It is a good one. But

9 we have got to make sure we do it right.

10 Senator Breaux. Well, let us work on it and

11 continue to work with Joint Tax on it.

12 The Chairman. Now that that amendment is withdrawn,

13 I would ask that the Chairman's mark, as amended, be

14 adopted. Those in favor, say aye.

15 [A chorus of ayes]

16 The Chairman. Those opposed, say no.

17 [No response]

18 The Chairman. We have two members that have

19 promised to come over here. We need three. All right.

20 Two members are coming. Then we can get this bill

21 passed.

22 Senator Baucus. Mr. Chairman, while we are waiting,

23 Senator Rockefeller has a very important statement that

24 he would like to introduce into the record.

25 The Chairman. All right.

1 Senator Baucus. You can read it.
2 The Chairman. Here is what we will do. Unless they
3 walk in the door in the next two minutes, I think what we
4 will do is adjourn and meet off the floor on the first
5 vote for final passage. So, unless you run into two
6 people as you are going out the door, we will momentarily
7 recess this committee. Just a minute.
8 Senator Baucus. I would just ask that any other
9 statements be included, too.
10 The Chairman. Yes. Any other statements will be
11 included, as well as Senator Rockefeller's.
12 [The prepared statements of Senator Rockefeller and
13 Senator Daschle appear in the appendix.]
14 [Whereupon, at 1:13 p.m. the meeting was recessed.]
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1 AFTER RECESS

2 [Whereupon, at 4:30 p.m. the meeting resumed in the

3 President's Room, U.S. Capitol Building, Room 216.]

4 The Chairman. We are now ready to vote on final

5 passage of S. 1637, the Jumpstart our Business Strength

6 (JOBS) Act.

7 The Clerk will call the roll.

8 The Clerk. Mr. Hatch?

9 Senator Hatch. Aye.

10 The Clerk. Mr. Nickles?

11 Senator Nickles. Nay.

12 The Clerk. Mr. Lott?

13 Senator Lott. Aye.

14 The Clerk. Ms. Snowe?

15 Senator Snowe. Aye.

16 The Clerk. Mr. Kyl?

17 Senator Kyl. Nay.

18 The Clerk. Mr. Thomas?

19 Senator Thomas. Aye.

20 The Clerk. Mr. Santorum?

21 Senator Santorum. Aye.

22 The Clerk. Mr. Frist?

23 Senator Frist. Aye.

24 The Clerk. Mr. Smith?

25 Senator Smith. Aye.

1 The Clerk. Mr. Bunning?

2 The Chairman. Aye, by proxy.

3 The Clerk. Mr. Baucus?

4 Senator Baucus. Aye.

5 The Clerk. Mr. Rockefeller?

6 Senator Rockefeller. Aye.

7 The Clerk. Mr. Daschle?

8 Senator Daschle. Aye.

9 The Clerk. Mr. Breaux?

10 Senator Breaux. Aye.

11 The Clerk. Mr. Conrad?

12 Senator Conrad. Aye.

13 The Clerk. Mr. Graham?

14 Senator Baucus. Aye, by proxy.

15 The Clerk. Mr. Jeffords?

16 Senator Baucus. Aye, by proxy.

17 The Clerk. Mr. Bingaman?

18 Senator Bingaman. Aye.

19 The Clerk. Mr. Kerry?

20 Senator Baucus. Aye, by proxy.

21 The Clerk. Mrs. Lincoln?

22 Senator Lincoln. Aye.

23 The Clerk. Mr. Chairman?

24 The Chairman. Aye.

25 The Clerk. Mr. Chairman, the tally is 19 ayes, 2

1 nays.

2 The Chairman. The bill is favorably reported.

3 I would further ask that the staff have the authority
4 to draft necessary technical and conforming changes to
5 the Chairman's mark.

6 Without objection, so ordered.

7 The meeting is adjourned.

8 [Whereupon, at 5:00 p.m. the meeting was concluded.]

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I N D E X

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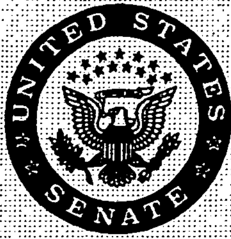

Committee On Finance
Max Baucus, Ranking Member
NEWS RELEASE http://finance.senate.gov

For Immediate Release
Wednesday, October 1, 2003

Contact: Laura Hayes
202-224-4515

STATEMENT OF SENATOR MAX BAUCUS
FINANCE COMMITTEE MARK-UP OF S. 1637
JUMPSTART OUR BUSINESS STRENGTH ACT (JOBS)

Today, we take an important step to help create and keep jobs here in America. As Americans know all too well, our country is losing jobs. Since February 2001, private sector employment in America has fallen by 3.3 million jobs, according to the Labor Department.

And the manufacturing sector has borne the brunt of this downturn. Since its peak in June 2000, manufacturing employment has declined continuously every month for 37 months. Manufacturing alone has lost 2.7 million jobs since then. Manufacturing has suffered across the country. Every state in the Union, except for Nevada, has lost manufacturing jobs. 49 out of 50 states have lost manufacturing jobs. Manufacturing makes up a quarter of Montana's economic base. These are good jobs, with good pay. And Montana has lost 13 percent of those jobs since 2000.

Manufacturing jobs are important to the entire economy. Manufacturing jobs create work in supporting industries and other sectors. And manufacturing has one of the highest job-creation multiplier effects. Every 16 million manufacturing jobs create another 9 million jobs in retail, wholesale, finance, and other sectors. The current job losses in the manufacturing sector thus affect the entire U.S. economy through reduced purchasing power, decreased consumption, and a shrinking tax base.

We cannot afford to let this job loss continue. We need to do something for the manufacturing sector. Today, we will act. Today, we will cut taxes for domestic manufacturers. And today, we will simplify taxes for American companies operating overseas. I am pleased that the Committee is today taking up this important bill that the Majority Leader, Chairman Grassley, Senator Hatch, and I have introduced. It will help prevent layoffs. It will help preserve jobs.

And another reason why we act today is to respond to an international tax case that the United States lost in the World Trade Organization (WTO). In a dispute brought by the European Union, the WTO found that the Foreign Sales Corporation (FSC) and Extraterritorial Income Act (ETI) were impermissible export subsidy programs.

As a result, the WTO has authorized over $4 billion in sanctions against U.S. exporters. The EU has threatened to impose these sanctions on January 1, 2004, if we have not complied with the WTO's ruling. Thus we need to replace FSC/ETI. And we need to replace it with a worthy substitute. The bill we consider today — the JOBS Act — does just that.

Our bill replaces a tax incentive that was dependant on exports with a tax incentive that is not dependant on exports. This bill will solve the WTO problem. Our bill will partially offset the loss of tax benefits to U.S. exporting companies from the repeal of FSC/ETI. And it will also provide benefits to all American manufacturers. It will provide a needed boost for this important sector.

STATEMENT OF SENATOR ORRIN G. HATCH
FOR FINANCE COMMITTEE MARKUP OF THE
JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT of 2003
October 1, 2003

I want to congratulate and thank you, Mr. Chairman, along with Senator Baucus, for your leadership in moving forward with this bill today. The legislation before us to repeal the Extraterritorial Income and Foreign Sales Corporation (or FSC/ETI) provisions, and to replace them with other tax benefits, has not been easy to put together. This is particularly true because of the revenue-neutral environment that bipartisanship today demands.

To be successful in this endeavor, we need a bill that is finely balanced and sensitive to the needs of both domestic manufacturing companies and to U.S.-based multinational firms. Your original mark was a good first step toward this goal and the modification we see here today represents further progress. Thank you for considering the changes I suggested, and for incorporating some of them into the bill.

All of us here are aware of the urgency of repealing the FSC/ETI provisions. We simply must do it in order to honor our commitments as a member of the World Trade Organization. This was made clear during my recent attendance at the WTO Cancun ministerial. The very real possibility of severe trade sanctions hangs over our heads if we fail.

I wish to point out, Mr. Chairman, that it is very important that we also not fail to take advantage of this opportunity to improve the tax rules that govern international business transactions. In today's global economy, often even the smallest businesses in my home State of Utah are looking at overseas markets. In fact, more than 80 percent of Utah's nearly 2,000 companies that export are small or medium-sized businesses.

As the Treasury Department points out in its explanation of its revenue proposals for this year, as we comply with the WTO directive, our focus should be on improving the global competitiveness of U.S. firms and U.S. workers. These international tax laws are badly outdated and act as an anchor tied to the feet of U.S. companies as they face global competition.

In 1962, eighteen of the twenty largest companies in the world were headquartered in the U.S. By the end of 2001, the number had dwindled to eight. We have seen long-time U.S. employers pack their bags and move their headquarters offshore. And new firms that might have otherwise started up in the U.S. too often decide to incorporate elsewhere. The root cause, Mr. Chairman, is our outdated tax code. We simply cannot retain our global leadership without tax laws that make sense for the 21st Century.

We make significant progress toward this objective in this bill. I look forward to making it even better as it progresses through the legislative process. Again, I thank the Chairman and Senator Baucus and their staffs for their hard work and leadership.

(Latest) (revised?)

STATEMENT OF SENATOR JOHN D. ROCKEFELLER, IV

SENATE FINANCE COMMITTEE MEETING
OCTOBER 1, 2003

Mr. Chairman, I want to thank you for the very difficult work that you and your staff have done to craft a responsible bill that offers assistance to our ailing manufacturing sector, simplifies and improves our international tax laws, and very importantly, does not add to our nation's already overwhelming deficit.

I believe that the most important provision we will consider today is the new tax deduction for domestic manufacturing activities. As the members of this Committee well know, our manufacturing sector has been disproportionately affected by our economic downturn. Since the beginning of 2001, when the recent recession began, the nation has lost 2.5 million manufacturing jobs. My home state of West Virginia has lost 12,000 factory jobs since manufacturing employment peaked in 1998.

These are good jobs being lost – the kinds of jobs that pay a living wage and include health insurance and pension benefits. The revitalization of the manufacturing sector is fundamental to our economic recovery.

I believe that a new deduction for domestic manufacturing is a constructive step toward breathing new life into our factories. The deduction provides a lower effective tax rate for companies that locate their operations and the jobs that go with them in the U.S. It will help our companies compete in the global marketplace, even as we repeal the foreign sales corporation tax provisions that have long benefited some of our largest manufacturers.

In creating this new tax benefit, however, I think that this Committee needs to acknowledge that all U.S. manufacturing jobs should be rewarded for employing U.S. workers, including jobs in U.S.-only companies and jobs in multinational companies like Dow, DuPont, Bayer, and Toyota.

I recognize and appreciate the modifications made to the mark that begin phasing out the foreign-domestic haircut in 2010 instead of 2012. However, this bill still limits the tax deduction for companies with overseas operations until 2013. Doing so has the effect of punishing certain multinational corporations relative to wholly domestic companies.

For more than two decades, I have worked very hard to encourage foreign companies to invest in and build facilities in my state. I am proud that West Virginia's excellent work force has attracted companies such as Toyota, which now employs about 1,000 people in Putnam County. And they rate as the most productive Toyota facility in North America.

Let me also raise the example of DuPont, a well-known and well respected American company for more than 200 years. As an exporter of chemicals and other products, DuPont will be significantly hurt by the repeal of the FSC/ETI provisions. Because it has substantial manufacturing operations in the U.S., including facilities in West Virginia that employ 2700 people, DuPont should benefit from the new deduction for manufacturing.

However, as written, this bill would limit the tax benefit to DuPont because it also has manufacturing operations overseas. To the employee at DuPont's plant in Washington, West Virginia, I cannot explain why the manufacturer he works for will get only half of the tax break that we are providing to other manufacturers in this bill. We ought to be focused on preserving American jobs by lowering the cost of doing business in the U.S.

Make no mistake, to get the benefit of this bill, any manufacturer must provide American jobs. They would get nothing for their foreign operations. But we should be actively courting the factories of foreign businesses and we should be encouraging our own global companies to maintain facilities in the U.S. I would not want us to treat global businesses like second class citizens. I hope that we are able to make more progress on this issue before the Senate votes on the bill.

I would like to raise another matter that troubles me about this legislation. It is my understanding that in the most recent modifications to the mark, a provision has been included to allow the Internal Revenue Service to essentially

contract out some of the task of collecting taxes. I am extremely troubled by this provision. Citizens have a right to expect the government to live up to its responsibility to do something as fundamental as tax collection. Private debt collection already has a poor track record and raises serious questions about efficiency and taxpayer privacy. I appreciate the Chairman's assurances that he will try to address these issues before the full Senate considers this bill. However, I do not believe that we will be able to improve this proposal enough to make it a good idea, because it fundamentally is an unwise and potentially dangerous policy. Therefore, I will support efforts to remove this provision.

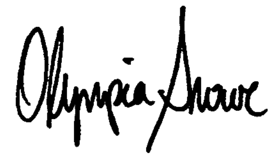
On another issue, I would like to take a moment to thank you for working with me to include a provision that has been very important to me for a number of years, a measure that promises to increase the deployment of the latest in broadband technology in rural and underserved communities across our country. This bill is essentially about maintaining America's competitiveness in an increasingly global marketplace, and I believe promoting broadband is a critical part of that effort.

Finally, Mr. Chairman, I thank you for accepting my amendment that requires the Commerce Department to report to Congress on whether in recent decisions the World Trade Organization exceeded its authority, adhered to the standard of review expressed in relevant WTO agreements, acted arbitrarily or capriciously, or required or established practices, analyses, or methodologies that are in conflict with those the U.S. understood to be incorporated in the relevant WTO agreements.

I believe it is very important that this Committee keep in mind how we arrived at this mark up today; namely we were compelled to respond to a WTO decision authorizing trade sanctions in retaliation for provisions of our tax code. I am simply asking the Commerce Department to evaluate WTO decisions and report to Congress on whether those decisions are consistent with U.S. obligations. I hope that all of the members of this Committee will see the value in this report and support my amendment.

Mr. Chairman, I look forward to working with you today on these and other issues. I am hopeful that the legislation

we approve today will be a good first step toward revitalizing our manufacturing sector and helping our ailing economy maintain and create good jobs.



Statement - Finance Committee Mark-Up
International Tax Legislation
October 1, 2003

Chairman Grassley, Senator Baucus, let me commend you for your efforts to bring forward this bipartisan mark before the Committee today to address the FSC/ETI issue.

This bill and this *mark-up* come not a moment too soon in bolstering an economy at a crossroads. America has been hard-hit by slow worldwide growth and significant job losses both during and after the recession, with unemployment recently reaching a high of 6.4 percent. Yet, *no* industry has witnessed a more *profound erosion* of jobs than U.S. manufacturers – and so we are *exactly right* to focus on strengthening this vital sector that has *also* been traditionally a source of quality jobs, decent wages and critical benefits.

The damage this sector has sustained is nothing short of stunning. From January 1993 through June 2003, nearly 2.7 million U.S. manufacturing jobs have been eliminated. Incredibly, New England lost more than 214,000 manufacturing jobs between June 1993 through June 2003, with fully 78 percent of those losses (166,000 jobs) occurring since January of 2001.

My home state of Maine has been *shedding* manufacturing jobs at an alarming rate over the past decade – and all the more so in the past two years. From January 1993 through June 2003, a ten-and-a-half year period, Maine lost 18,900 manufacturing jobs and *astoundingly* more than 15,000 of those losses occurred between January 2001 and June 2003. So we are *far* from headed in the right direction.

So there should be no doubt of the need to bolster our manufacturing industry. If we are to ensure the road to recovery is robust – and knowing that for every dollar of manufacturing output, $2.26 are generated in other sectors of our economy – we have a *special* obligation to provide the tools for growth in manufacturing.

It is not enough that the tax policy in this bill focus on profitability for U.S. companies – it must specifically foster the creation of *jobs*. Earlier this year, I raised the concern that even as the economy begins to grow, we may be facing a "jobless recovery." With continued uncertainties still in the job market, we must exercise caution as we reform the way businesses are taxed. We cannot afford to let this opportunity pass without sensible tax incentives to encourage the creation of jobs.

Therefore, I have proposed legislation to expand the benefits of the Work Opportunity Tax Credit to workers who have been laid off due to trade and are receiving Trade Adjustment Assistance (TAA). The proposal would give employers a tax credit of up to $2,400 for the wages paid to a recently hired TAA recipient. Giving employers a tax incentive to hire these workers will help put them back to work and, as a byproduct, lessen the load on the TAA program – what I would call a "dual win".

Moreover, as Chair of the Small Business Committee, I am acutely aware of small businesses' role in our economic recovery. With small businesses accounting for 97.5 percent of Maine businesses...98 percent of America's manufacturing enterprises...and contributing three-quarters of all new jobs nationwide...*whatever* we do should continue this trend and reinvigorate America's entrepreneurial spirit.

I think we all agree that allowing small businesses to expense certain

investments in productive assets stimulates growth and, in turn, new jobs. I appreciate the Chairman including my proposal to extend and *expand* the current section 179 limits on small business expensing – small business manufacturers would greatly benefit under this proposal.

Also included is the "Small Business Investment Company Capital Access Act of 2003" which I introduced earlier this year. The bill would correct a current limit on access to capital by excluding government guaranteed capital of Debenture SBICs from debt for purposes of the UBTI rules. This change would permit tax-exempt organizations to invest in SBICs without the burdens of UBTI record keeping or tax liability. As a result, this proposal would increase small business' access to capital, enabling them to grow and hire new employees.

Many of the jobs lost in Maine – as well as elsewhere – have occurred in the forest products industry, a sector that is *integral* to the economy in my home state and many others represented on this Committee. As we target the funds from repeal of the FSC/ETI tax exclusion to manufacturers, I intend to ensure that the forest products industry is not left out of any new tax relief, but strengthened through the Finance Committee bill.

Specifically, owners of timber lands should be able to deduct the cost of their reforestation activities more quickly. I have proposed additional expensing for this beneficial activities. Since these activities are labor intensive, encouraging more reforestation activities would not only be good for the environment, but will also create jobs. I am happy to see the Chairman's proposal includes a provision that allows for some expensing and allows taxpayers to write-off these costs more quickly. I am also pleased that the bill contains other important changes for the forest products industry, including expanding the benefits of the new manufacturers tax deduction to

softwood timber.

Another industry important to this nation, is the building of ships for the U.S. Navy. Currently, the tax accounting method imposed on this industry is unfairly creating a financial burden on their operations. I have proposed modifications to the tax accounting treatment for naval shipbuilders that is more sensible and more equitable. While this bill does not include my proposal, I appreciate the commitment of Chairman Grassley to work with me to find a solution to correct the problem for naval shipbuilders. I look forward to working with the Chairman on a solution before this bill reaches the Senate floor.

Mr. Chairman, overall the mark we have before us is carefully crafted and a well balanced proposal. It is a good start and leads us in the right direction. Of course, there are things that I would like to see changed and I will offer amendments to do that. Yet, in the end, I hope we can achieve the dual goal of meeting our WTO commitments by repealing the FSC/ETI regime and providing much needed additional tax relief that is targeted to bolster our manufacturing base and enhance the competitiveness of the U.S. based businesses. Again, I thank the Chairman.

STATEMENT FOR THE RECORD
FINANCE COMMITTEE BUSINESS MEETING ON THE JUMPSTART OUR BUSINESS STRENGTH ACT
OCTOBER 2, 2003

Senator Bunning:

Mr. Chairman, I have filed an amendment with my colleague senator Breaux that will address an unfair tax burden that is faced by wholesalers of domestic distilled spirits. The goal of this amendment is to equalize the impact of the federal excise taxes on distilled spirits between imported and domestically produced spirits.

Without going into details today, I can assure the committee that, as a result of a timing difference in the payment of the excise tax, it is often more expensive for a wholesaler to handle domestic spirits than imported spirits. This is not an equitable result. The Bunning-Breaux amendment would correct this imbalance.

Mr. Chairman, I understand that you have asked that we defer this issue for today and address it within the context of a later bill that will address excise tax issues specifically. I will agree to defer this very important issue for the time being, with the understanding that you will work with me in the near future to address it.

Chairman Grassley:

As you know I have directed the Finance Committee tax staff to prepare a bipartisan Excise Tax Reform and Simplification package and I truly appreciate you working with me on the proposed simplification package. I recognize the importance of this issue to you and I will ask my staff to work closely with your office with the hope that we will be able to include this proposal in that package. Thank you for your cooperation.

United States Senate Committee on Finance
October 1, 2003

Hearing

To Consider a Substitute to S. 1637, the
Jumpstart Our Business Strength (JOBS) Act of 2003

Written Statement of
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Introduction

My name is Martin B. Tittle. I am a licensed attorney in the state of Michigan, and I am employed as a researcher at the University of Michigan Law School in Ann Arbor. One of my research topics for the past fifteen months has been the Foreign Sales Corporation and Extraterritorial Income Exclusion Act cases in the World Trade Organization (WTO) and the U.S. response to those cases. I recently authored an article titled "U.S. ETI Repeal and Transition Relief" which was published in Tax Notes International and Worldwide Tax Daily,[1] and my comments below are drawn in large part from that article. My statement is submitted on my own behalf and not on behalf of any government or private entity.

The General Transition Relief in the Jumpstart Our Business Strength (JOBS) Act of 2003 is Likely Not WTO-Compliant

Section 101(e) of the Jumpstart Our Business Strength (JOBS) Act of 2003 (JOBS Act),[2] provides a general transition period for taxable years beginning before January 2007 during which "a current FSC/ETI beneficiary shall be allowed a deduction equal to the transition amount determined under this subsection." After the Committee's October 1 hearing on the JOBS Act, EU spokesperson Arancha Gonzalez was widely quoted in the press as saying, "We have already waited for three years to get the [FSC] legislation repealed, and therefore an extra three-year period couldn't be acceptable to us."[3]

Committee Chairman Charles E. Grassley responded, saying, "I'm surprised the European Union would threaten sanctions now. . . . The fact is the transition does not continue, in [Ms. Gonzalez's] words, 'a scheme that was declared illegal by the WTO.' Unlike the ETI, there is absolutely no requirement in our bill to export a single item to benefit from the transition."[4]

The Seattle Times expanded on this rationale in an October 3 story, saying "U.S. lawmakers and company representatives say that the transition in the current legislation is compatible with WTO rules because it is based on export figures from last year, and so won't be an incentive or subsidy to future sales."[5]

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[1] *See* Martin B. Tittle, "U.S. ETI Repeal and Transition Relief," 32 Tax Notes Int'l 43, 2003 Worldwide Tax Daily 193-16 (Oct. 3, 2003); *see also* Martin B. Tittle, "Follow-Up Regarding Binding Contract Relief and the Thomas ETI Repeal Bill," 32 Tax Notes Int'l 153 (Oct. 13, 2003), 2003 Worldwide Tax Daily 198-17 (Oct. 14, 2003).

[2] Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. (visited Oct. 14, 2003) <http://thomas.loc.gov>.

[3] *See, e.g.*, Shailagh Murray and Matthew Newman, "Congress Seeks an End to Export-Tax Break," Wall St. J., Oct. 3, 2003.

[4] Charles E. Grassley, "Grassley 'Surprised' at EU Spokesperson's Comments on U.S. ETI Repeal," 2003 Worldwide Tax Daily 192-11 (Oct. 3, 2003).

[5] Jonathan Stearns, "E.U. Threatens $4 Billion in Sanctions[;] Trade War Looms Over Repeal of Tax Credit," The Seattle Times, Oct. 3, 2003, at C1.

Similar arguments have been made regarding the WTO compliance of the general transition provision in the Job Protection Act of 2003,[6] sometimes called the "Crane-Rangel" bill, and in fact, the general transition provisions in the JOBS Act and the Crane-Rangel bill are comparable in that "they are not extensions of [the FSC Repeal and Extraterritorial Income Exclusion Act of 2000[7] (ETI)], as the ETI [transition] rule was of FSC, but rather are separate subsidies that are based on whether a company qualified for FSC/ETI benefits in 2001 [in the case of the Crane-Rangel bill] or 2002 [in the case of the JOBS Act]."[8] Last July, in a "Dear Colleague" letter, Reps. Philip M. Crane, Charles B. Rangel, Sander M. Levin, and Donald A. Manzullo made the following argument in favor of the WTO-compliance of the general transition provision in the Crane-Rangel bill:

> The general transition relief, like the effective rate reduction, is not export-contingent. WTO rules prohibit export-contingent subsidies, not subsidies to companies that have exported in the past. As footnote 4 to the WTO Subsidies Agreement states: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision."
>
> The standard legal meaning of "contingent" is "possible, but not assured, doubtful or uncertain, conditioned upon the occurrence of some future event which is itself uncertain." The general transition relief is not export-contingent; if the taxpayers receiving general transition relief have zero exports, they will nonetheless receive the full general transition relief. Under the transition provision, no manufacturer is required in any way to export anything to receive the transition benefits. There simply is no incentive whatever to export. In fact, the general transition relief is not contingent upon anything. It is guaranteed to recipients; receipt of these benefits is assured and is not conditioned upon any future uncertain event. A measure that applies regardless of export performance is not in any way "contingent," "dependent," or "conditional" upon export performance.[9]

This defense is congruent with Chairman Grassley's statement that "there is absolutely no requirement in our bill to export a single item to benefit from the transition," and at first glance, the argument it presents looks promising. The cited "standard legal meaning" of "contingent"

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[6] Job Protection Act of 2003, H.R. 1769, 108th Cong. (visited Aug. 29, 2003) <http://thomas.loc.gov>.

[7] FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519; 114 Stat. 2423 (codified at I.R.C. §§ 114, 941-943).

[8] Martin B. Tittle, "U.S. ETI Repeal and Transition Relief," *supra* note 1, at 45 (footnotes omitted).

[9] Philip M. Crane *et al.*, "U.S. Job Protection Act Sponsors Explain Bill," 2003 Worldwide Tax Daily 143-21 paras. 13-14 (July 25, 2003).

appears word for word in the Sixth Edition of Black's Law Dictionary, and there is no doubt that the WTO sometimes uses Black's as an authority to define terms in the WTO agreements.[10]

The problem is the WTO Appellate Body has already defined "contingent" as that word is used in the export subsidy prohibition, saying it just means "conditional" or "dependent for its existence on something else."[11] This definition contains no reference to a future uncertain event, as the definition in Black's does, and thus would allow the WTO to find that the new subsidy's dependence on past export performance violates WTO rules. While it is remotely possible the WTO could be persuaded to change its definition of "contingent,"[12] the process involved in

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[10] *See, e.g.*, WTO, Report of the Appellate Body, *United States - Section 211 Omnibus Appropriations Act of 1998*, WT/DS176/AB/R (Jan. 2, 2002) para. 187 n.123 (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/176ABR.doc>.

[11] WTO, Report of the Appellate Body, *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (Aug. 2, 1999) para. 166 (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/70ABR.doc>. This definition has been cited in other Appellate Body decisions, including WTO, Report of the Appellate Body, *Canada - Certain Measures Affecting the Automotive Industry*, WT/DS139/AB/R (May 31, 2000) para. 98 (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/139ABR.doc> and WTO, Report of the Appellate Body, *United States – Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW (Jan. 14, 2002) para. 111 (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ABRW.doc>

[12] Mike Castellano, Trade and Tax Counsel for Crane-Rangel co-sponsor Sander Levin, has pointed out that the Appellate Body has never (to his recollection) addressed a subsidy based on prior export performance, and that this new issue could warrant an extension of the current definition of "contingent." E-mail from Mike Castellano to Martin B. Tittle (Sept. 17, 2003) (on file with the author). He has also noted that subsidies based on past export performance do not implicate the market distortion rationale that underlies the prohibition of subsidies based on current or future exports. *Id.* The WTO would probably not be persuaded by these arguments because their adoption in this case would effectively allow the U.S. to create additional, ETI-clone benefits after ETI had been declared illegal and pay out those extra benefits over time. That result would completely undermine the intent of the export subsidy proscription, article 3.1(a) of the Agreement on Subsidies and Countervailing Measures (SCM), and therefore violate the rule that "an interpreter is not free to adopt a reading that would reduce whole clauses of a treaty to redundancy or inutility." WTO, Report of the Panel, *United States – Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW (Aug. 20, 2001) para. 8.39 n.106 (visited Sept. 17, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108RW-00.doc>. The fact that both the Crane-Rangel and JOBS Act general transition rules are not a direct continuation of ETI would probably be viewed as highly formalistic because both rules are customized for each recipient based on the individual business's "aggregate FSC/ETI benefits for the . . . taxable year beginning in calendar year" 2001/2002. *See* Job Protection Act of 2003, *supra* note 6, sec. 2(e)(4)(B) (calendar year 2001); Jumpstart Our Business Strength (JOBS) Act, *supra* note 2, sec. 101(e)(4) (calendar year 2002); *cf.* WTO, Report of the Panel, *United States – Tax Treatment for*

raising that issue would likely not require the EU to forgo application of its approved FSC/ETI sanctions. If Chairman Grassley's defense of the JOBS Act's general transition provision does not exceed the bounds of the Crane-Rangel arguments, it too will likely not be persuasive.

The WTO "mutual agreement" procedure

The strong possibility that the JOBS Act's general transition provision is not WTO-compliant "on the merits" does not mean that it cannot prevail. On the contrary, under the "mutual agreement" procedure in article 3.6 of the WTO Dispute Settlement Understanding (DSU),[13] it is entirely within the power of the EU and the U.S. to decide that, WTO-noncompliance notwithstanding, they want to resolve this matter by allowing some transition period. That is exactly what happened in 2001 when the U.S. held the winning hand in the *Bananas* dispute with the EU: it agreed to allow the EU, which was already $2^{1}/2$ years past its original WTO deadline for compliance, an additional $4^{1}/2$-year transition period during which the U.S. would not impose its WTO-authorized sanctions.[14] While the EU has no legal obligation to reciprocate now that the shoe is on the other foot, the "Dear Colleague" letter of Rep. Crane *et al.* is right that "it would be difficult to justify" nonreciprocation.[15]

A logical standard for the appropriate level of reciprocation would be the number of years between the original WTO deadline for compliance with the *Bananas* decision and the new deadline reached in the 2001 "mutual agreement." The original deadline was January 1, 1999,[16]

"Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, supra, paras. 8.37-8.38 (criticizing the revised definition of gross income in ETI as "highly formalistic" and "difficult to reconcile with the text and context of Article 1.1(a)(1)(ii) in light of the object and purpose of the [SCM]").

[13] DSU Article 3.6 reads, "Mutually agreed solutions to matters formally raised under the consultation and dispute settlement provisions of the covered agreements shall be notified to the DSB [Dispute Settlement Body] and the relevant Councils and Committees, where any Member may raise any point relating thereto." Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 31 (1994) (visited Aug. 29, 2003) <http://www.wto.org/english/docs_e/legal_e/28-dsu.doc>.

[14] *See* WTO, *European Communities – Regime for the Importation, Sale And Distribution of Bananas, Notification of Mutually Agreed Solution*, WT/DS27/58 (July 2, 2001) (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/27-58.doc>; WTO, *European Communities – Transitional Regime for the EC Autonomous Tariff Rate Quotas on Imports of Bananas*, WT/MIN(01)/16 (Nov. 14, 2001) (visited Aug. 29, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/min01/16.doc>.

[15] *See* Philip M. Crane *et al., supra* note 9, para. 11.

[16] *See* WTO, Award of the Arbitrator, *European Communities - Regime for the Importation, Sale and Distribution of Bananas [-] Arbitration under Article 21.3(c) of the* [DSU], WT/DS27/15

and the agreement the EU reached with the U.S. extended that deadline to January 1, 2006,[17] a period of seven years. The original deadline for the U.S. in the *FSC* case was October 1, 2000.[18] Therefore, a transition period parallel in scope with the extra, overall compliance time the EU is now enjoying in *Bananas* would extend the U.S. *FSC* deadline to October 1, 2007, or about four years from the present.[19]

Some observers focus on the fact that the *Bananas* agreement gave the EU an additional five years to comply and argue that the U.S. should receive an identical extension in any *FSC* agreement. That standard, however, would effectively place a premium on the time that passed before the WTO "mutual agreement" procedure was invoked. Losing parties whose cases generated a longer pre-agreement period would be rewarded with greater overall transition relief, while those who, for whatever reason, reached agreement more quickly would be penalized. This potential timing element, and the bickering that could accompany it, are neutralized in advance if reciprocation is based simply on the actual, total extension of the original WTO deadline.

Conclusion

Although the general transition provision in the JOBS Act is probably not WTO-complaint, it can and should be implemented under the WTO's "mutual agreement" procedure. When the U.S. held the winning hand in the *Bananas* dispute with the EU, it waited 2½ years past the original WTO deadline for compliance, and then, in 2001, signed a voluntary agreement giving the EU an additional 4½-year transition period. If the EU did no more than respond in kind and give the U.S. equal time to comply with the deadline in the *FSC* case, the U.S. would be entitled to a transition period ending (at the earliest) October 1, 2007. That would be nine months longer than the January 2007 deadline for total compliance set in the JOBS Act.

Apparently, a seven-year transition period did not seem like too much to the EU when it was on the receiving end in *Bananas*. Therefore, it should agree to allow the U.S. a shorter period now that the shoe is on the other foot.

(Jan. 7, 1998) para. 20 (visited Sept. 17, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/27-15.wpf>.

[17] *See* WTO, *European Communities – Regime for the Importation, Sale And Distribution of Bananas, Notification of Mutually Agreed Solution, supra* note 14.

[18] *See* WTO, Report of the Panel, *United States – Tax Treatment for "Foreign Sales Corporations,"* WT/DS108/R (Oct. 8, 1999) para. 8.8 (visited Sept. 17, 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108R.doc>.

[19] The JOBS Act comes fairly close to this proposed deadline extension. Its general transition provision provides for benefits on a declining basis until Jan. 1, 2007. *See* Jumpstart Our Business Strength (JOBS) Act, *supra* note 2, sec. 101(e).

JOINT COMMITTEE ON TAXATION
September 24, 2003
JCX-82-03

ESTIMATED REVENUE EFFECTS OF THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT"

Fiscal Years 2004 - 2013

[Millions of Dollars]

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
Provisions Relating to Repeal of Exclusion for Extraterritorial Income													
1. Repeal of exclusion for extraterritorial income [1]	toa DOE	3,710	4,780	5,093	5,312	5,508	5,727	5,993	6,258	6,518	6,789	24,403	55,688
2. Deduction relating to income attributable to United States production activities	tyea DOE	-339	-835	-1,609	-3,510	-4,340	-4,947	-6,094	-6,300	-7,682	-9,952	-10,633	-45,608
Total of Provisions Relating to Repeal of Exclusion for Extraterritorial Income		**3,371**	**3,945**	**3,484**	**1,802**	**1,168**	**780**	**-101**	**-42**	**-1,164**	**-3,163**	**13,770**	**10,080**
General Transition for Repeal of Exclusion for Extraterritorial Income	toa DOE & before 2007	-3,105	-3,234	-2,682	-765	---	---	---	---	---	---	-9,786	-9,786
International Tax Provisions													
A. International Tax Reform													
1. Extend the foreign tax credit carryforward from 5 years to 20 years	[2]	---	-266	-343	-412	-577	-767	-941	-1,080	-1,253	-1,453	-1,598	-7,092
2. Apply look-through rules for dividends from noncontrolled section 902 corporations	tyba 12/31/02	-585	-77	-51	-23	-6	-1	[3]	[3]	[3]	[3]	-742	-743
3. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	---	-236	-355	-338	-334	-333	-334	-338	-344	-352	-1,263	-2,964
4. Recharacterize overall domestic loss	lf tyba 12/31/06	---	---	---	-57	-680	-713	-756	-793	-829	-862	-737	-4,690
5. Revision of interest allocation rules	tyba 12/31/09	---	---	---	---	---	---	-963	-2,586	-2,689	-2,797	---	-9,035
6. Determination of foreign personal holding company income with respect to transactions in commodities	teia 12/31/04	---	-4	-10	-10	-10	-10	-11	-11	-11	-11	-34	-88
B. International Tax Simplification													
1. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules	[4]	---	-25	-65	-73	-81	-91	-102	-114	-128	-143	-244	-822
2. Expand the subpart F de minimis rule to the lesser of 5% of gross income or $5 million	[4]	---	-15	-143	-157	-173	-190	-209	-230	-253	-279	-488	-1,649
3. Attribution of stock ownership through partnerships in determining section 902 and 960 credits	tyba DOE	[3]	-1	-3	-3	-3	-3	-3	-3	-3	-3	-10	-25
4. Limit application of uniform capitalization rules in the case of foreign persons	tyba 12/31/04	---	-125	-278	-79	-27	-8	-12	-14	-16	-18	-509	-577
5. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations	pma 12/31/04	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
6. Eliminate 30% tax on certain U.S.-source capital gains of nonresident individuals	tyba 12/31/03	---	-2	-2	-2	-3	-3	-3	-3	-3	-3	-9	-24
Total of Simplification Proposals		-585	-753	-1,253	-1,157	-1,897	-2,122	-3,337	-5,175	-5,532	-5,924	-5,645	-27,735
Interaction	---	13	14	16	17	19	21	245	620	646	674	79	2,285
NET TOTAL		-306	-28	-435	-103	-710	-1,321	-3,193	-4,597	-6,050	-8,413	-1,582	-25,156

Joint Committee on Taxation

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

Legend for "Effective" column:
DOE = date of enactment
lf = losses for
pma = payments made after
teia = transactions entered into after
toa = transactions occurring after
tyba = taxable years beginning after
tyea = taxable years ending after

[1] Includes estimate for binding contract relief.
[2] Effective for excess foreign taxes that may be carried forward to any taxable year beginning after December 31, 2004.
[3] Loss of less than $1 million.
[4] Effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. persons owning stock of such corporations with or within such corporations' taxable years end.

DESCRIPTION OF THE CHAIRMAN'S MARK OF THE "JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on October 1, 2003

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

September 26, 2003
JCX-83-03

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on October 1, 2003, of S. 1637, the "Jumpstart Our Business Strength (JOBS) Act," together with additional provisions not included in S. 1637 as introduced. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of S. 1637 and these additional provisions.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of the "Jumpstart Our Business Strength (JOBS) Act"* (JCX-83-03), September 26, 2003.

I. PROVISIONS RELATING TO REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME

A. Repeal of Exclusion for Extraterritorial Income (sec. 101 of the bill and secs. 114 and 941-943 of the Code)

Present Law

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

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

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

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

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

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

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

Description of Proposal

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

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

The proposal also provides a deduction for taxable years of certain corporations ending after the date of enactment of the proposal and beginning before January 1, 2007.[4] The amount of the deduction for each such taxable year is equal to a specified percentage of the aggregate amount that, for the taxable year of a corporation beginning in 2002, was excludable from the gross income of the corporation under the extraterritorial income exclusion provisions or was treated by the corporation as exempt foreign trade income of related FSCs from property acquired by the FSCs from the corporation. However, this aggregate amount does not include any amount attributable to a transaction involving a lease by the corporation unless the corporation manufactured or produced (in whole or in part) the leased property.

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

The specified percentage to be used in determining the deduction is: 80 percent for calendar years 2004 and 2005; 60 percent for calendar year 2006; and 0 percent for calendar year 2007 and calendar years thereafter. For calendar year 2003, the specified percentage is the amount that bears the same ratio to 100 percent as the number of days after the date of enactment of this proposal bears to 365. In the case of a corporation with a taxable year that is not the calendar year (i.e., a fiscal year corporation), a special rule is provided for determining a weighted average specified percentage based upon the calendar years that are included in the taxable year.

The deduction for a taxable year generally is reduced by the specified percentage of exempted FSC income and excluded extraterritorial income of the corporation for the taxable year from transactions pursuant to a binding contract. However, this reduction does not apply to income attributable to transactions involving a lease by the corporation of property that the corporation has not manufactured or produced (in whole or in part).

Effective Date

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

B. Deduction Relating to Income Attributable to United States Production Activities (sec. 102 of the bill and new sec. 250 of the Code)

Present Law

Under present law, there is no provision in the Code that permits taxpayers to claim a deduction from taxable income attributable to domestic production activities, other than allowable deductions of costs incurred to produce such income.

Description of Proposal

In general

The proposal provides a deduction for qualified production activities income of a corporation. The amount of the deduction for such income in taxable years beginning in: 2004 is one percent; 2005 is two percent; 2006 is three percent; 2007 and 2008 is six percent; and 2009 and thereafter is nine percent.

Qualified production activities income

"Qualified production activities income" is the product of an applicable percentage multiplied by the modified taxable income[5] of a corporation that is attributable to domestic production activities. In general, income attributable to domestic production activities is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;[6] (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[7]

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[5] "Modified taxable income" is taxable income of the corporation computed without regard to the deduction provided by this proposal. Qualified production activities income is limited to the modified taxable income of the corporation.

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

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

For taxable years beginning before 2012, the "applicable percentage" is the value of the domestic production of the corporation divided by the value of the worldwide production of the corporation (the "domestic/worldwide fraction").[8] For taxable years beginning in 2012, the applicable percentage is equal to twice the domestic/worldwide fraction. For taxable years beginning after 2012, the applicable percentage is 100 percent.

Domestic production gross receipts

"Domestic production gross receipts" are gross receipts of a corporation that are derived from any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States.[9] "Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(3) or (4) of the Code. However, qualifying production property does not include: (1) consumable property that is sold, leased or licensed as an integral part of the provision of services; (2) oil or gas (or any primary product thereof); (3) electricity; (4) water supplied by pipeline to the consumer; (5) unprocessed timber (i.e., any log, cant or similar form of timber) that is softwood; (6) utility services; and (7) any film, tape, recording, book, magazine, newspaper or similar property the market for which is primarily topical or otherwise essentially transitory in nature.

Other rules

Distributions of qualified production activities income by cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the proposal provides the same treatment of qualified production

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

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

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

Qualified production activities income of partnerships and S corporations

For purposes of determining the deduction under the proposal, a corporate partner's distributive share of any partnership item shall be taken into account as if directly realized by the corporation. Thus, the qualified production activities income of a corporation includes its distributive share of such income earned by a partnership in which the corporation is a partner.

The deduction provided by the proposal is allowed to S corporations, computed in the same manner as C corporations. The deduction allowed to an S corporation passes through and is allowed to the S corporation shareholders on their individual tax returns. The adjusted basis of a shareholder's stock in the S corporation is increased by the amount of the shareholder's deduction allowed under the proposal.

Alternative minimum tax

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

Coordination with ETI repeal

For purposes of determining the deduction provided by this proposal, domestic production gross receipts does not include gross receipts from any transaction that produces excluded extraterritorial income pursuant to the binding contract exception to the ETI repeal provisions of this proposal.

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

Effective Date

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

II. INTERNATIONAL TAX PROVISIONS

A. International Tax Reform

1. Twenty-year foreign tax credit carryforward (sec. 201 of the bill and sec. 904 of the Code)

Present Law

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

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years (to the earliest year first) and carried forward five taxable years (in chronological order) and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. Excess credits that are carried back or forward are usable only to the extent that there is excess foreign tax credit limitation in such carryover or carryback year. Consequently, foreign tax credits arising in a taxable year are utilized before excess credits from another taxable year may be carried forward or backward. In addition, excess credits are carried forward or carried back on a separate limitation basis. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits may be carried back and forward only as taxes allocable to that category, notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year. If credits cannot be so utilized, they are permanently disallowed.

Description of Proposal

The proposal extends the excess foreign tax credit carryforward period from five to twenty years.

Effective Date

The proposal is effective for excess foreign tax credits that may be carried to any taxable years beginning after December 31, 2004.

2. Look-through rules to apply to dividends from noncontrolled section 902 corporations (sec. 202 of the bill and sec. 904 of the Code)

Present Law

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

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

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

Description of Proposal

The proposal applies the look-through approach to all dividends paid by a 10/50 company that is not a passive foreign investment company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. In the event that information is not available to apply the look-through approach with respect to all or a portion of the dividend, such portion is treated as passive category income for foreign tax credit basketing purposes.

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

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

Effective Date

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

3. Foreign tax credit under alternative minimum tax (sec. 203 of the bill and secs. 53-59 of the Code)

Present Law

In general

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

Foreign tax credit

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

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

Description of Proposal

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

Effective Date

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

4. Recharacterization of overall domestic loss (sec. 204 of the bill and sec. 904 of the Code)

Present Law

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

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

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

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

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

the fact that the previous year's $100 U.S.-source loss reduced the taxpayer's ability to claim foreign tax credits.

Description of Proposal

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

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

Any U.S.-source income recharacterized under the proposal is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

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

Effective Date

The proposal applies to losses incurred in taxable years beginning after December 31, 2006.

5. Interest expense allocation rules (sec. 205 of the bill and sec. 864 of the Code)

Present Law

In general

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

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below.) The Code provides that, for interest allocation purposes, all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule") and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

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

Definition of affiliated group -- consolidated return rules

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

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

Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[11] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is

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

considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

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

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

Description of Proposal

In general

The proposal modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over (2) the interest expense incurred by a foreign member of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[12]

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

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[13] as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[14] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

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

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2005, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

__Financial institution group election__

The proposal allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The proposal also provides a one-time "financial institution group" election that expands the present-law bank group. Under the proposal, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1)

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

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

all corporations that are part of the present-law bank group,[15] and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[16] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2009, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the proposal provides anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The proposal provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, or address changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2009.

6. Determination of foreign personal holding company income with respect to transactions in commodities (sec. 206 of the bill and sec. 954 of the Code)

Present Law

Subpart F foreign personal holding company income

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

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[15] No inference is intended as to the treatment under present law with respect to financial holding companies (within the meaning of section 2(p) of the Bank Holding Company Act of 1956), as well as subsidiaries of financial holding companies that are predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business. With respect to financial holding companies that make a financial institution group election under the proposal, no inference is intended as to the application of present law to such taxpayers for taxable years prior to the taxable year for which such an election is made.

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

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

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[17] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[18]

Hedging transactions

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe) (sec. 1221(a)(7)). The term "hedging transaction" means any transaction entered into by the

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

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

taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations (sec. 1221(b)(2)(A)).

Description of Proposal

The proposal modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the proposal, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this provision, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2) (sec. 1221(a)(7) and (b)(2)(B)).

The proposal also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the proposal, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[19]

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

For purposes of the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income, the proposal also provides that certain commodities held by a controlled foreign corporation that is a regular dealer in commodities or financial instruments referenced to commodities are not taken into account in determining whether substantially all of the controlled foreign corporation's commodities are comprised of the property described above.

Effective Date

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

B. International Tax Simplification

1. Repeal of foreign personal holding company rules and foreign investment company rules (sec. 211 of the bill and secs. 542, 551-558, 954, 1246, and 1247 of the Code)

Present Law

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

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

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

Description of Proposal

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

Effective Date

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

2. Expansion of de minimis rule under subpart F (sec. 212 of the bill and sec. 954 of the Code)

Present Law

Under the rules of subpart F (secs. 951-964), U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently for U.S. tax purposes certain

types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income and certain insurance income. Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). Under a de minimis rule, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $1 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income (sec. 954(b)(3)(A)).

Description of Proposal

The proposal expands the subpart F de minimis rule to provide that, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $5 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income.

Effective Date

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

3. Attribution of stock ownership through partnerships to apply in determining section 902 and 960 credits (sec. 213 of the bill and secs. 901 and 902 of the Code)

Present Law

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

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

application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

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

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[20] In Rev. Rul. 71-141,[21] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distributed from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[22] In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, when adopting the 1997 final regulations, the IRS left uncertainty over whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

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

[21] 1971-1 C.B. 211.

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

Description of Proposal

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

Effective Date

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

4. Application of uniform capitalization rules for foreign persons (sec. 214 of the bill and sec. 263A of the Code)

Present Law

Taxpayers generally may not currently deduct the costs incurred in producing property or acquiring property for resale. In general, the uniform capitalization rules require that a portion of the direct and indirect costs of producing property or acquiring property for resale be capitalized or included in the cost of inventory (sec. 263A). Consequently, such costs must be recovered through an offset to the sales price if the property is produced for sale, or through depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. The purpose of this requirement is to match the costs of producing or acquiring goods with the revenues realized from their sale or use in the business or investment activity.

The uniform capitalization rules apply to foreign corporations, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in a trade or business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation may be currently includible on the return of a U.S. shareholder of the controlled foreign corporation. Regardless of whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the amount of taxable dividends and the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The earnings and profits surplus or deficit of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations. However, Treas. Prop. Reg. sec. 1.964-1(c)(1)(ii)(B) provides that, for purposes of computing a foreign corporation's earnings and profits, the amount of expenses that must be

capitalized into inventory under the uniform capitalization rules may not exceed the amount capitalized in keeping the taxpayer's books and records. For this purpose, the taxpayer's books and records must be prepared in accordance with U.S. generally accepted accounting principles for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates. This proposed regulation applies only for purposes of determining a foreign corporation's earnings and profits and does not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

Description of Proposal

The proposal provides that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale are capitalized using U.S. generally accepted accounting principles (i.e., the method used to ascertain income, profit, or loss for purposes of reports or statements to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes) for purposes of determining a U.S.-owned foreign corporation's earnings and profits and subpart F income. The uniform capitalization rules continue to apply to foreign corporations for purposes of determining income effectively connected with a U.S. trade or business and the related earnings and profits therefrom.

Effective Date

The proposal applies to taxable years beginning after December 31, 2004. Any change in the taxpayer's method of accounting required as a result of this provision is treated as a voluntary change initiated by the taxpayer and is deemed made with the consent of the Secretary of the Treasury (i.e., no application for change in method of accounting is required to be filed with the Secretary). Any resultant section 481(a) adjustment required to be taken into account is to be taken into account in the first year.

5. Repeal of withholding tax on dividends from certain foreign corporations (sec. 215 of the bill and sec. 871 of the Code)

Present Law

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

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

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

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

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

Description of Proposal

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

Effective Date

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

6. Repeal of special capital gains tax on aliens present in the United States for 183 days or more (sec. 216 of the bill and sec. 871 of the Code)

Present Law

In general

In general, resident individuals who are not U.S. citizens are taxed in the same manner as U.S. citizens. Nonresident individuals who are not U.S. citizens are subject to (1) U.S. tax on

income from U.S. sources that are effectively connected with a U.S. trade or business, and (2) a 30-percent withholding tax on the gross amount of certain types of passive income derived from U.S. sources, such as interest, dividends, rents, and other fixed or determinable annual or periodical income (sec. 871(a)(1)). Bilateral income tax treaties may modify these tax rules.

Taxation of capital gains

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller (sec. 865(a)). Thus, nonresident individuals who are not citizens generally are not taxable on capital gains because the gains generally are considered to be foreign-source income.[23]

Special rules apply in the case of sales of personal property by certain foreign persons. In this regard, an individual who is otherwise treated as a nonresident is treated as a U.S. resident for purposes of sourcing income from the sale of personal property if the individual has a tax home in the United States (sec. 865(g)(1)(A)(i)(II)). An individual's U.S. tax home generally is the place where the individual has his or her principal place of business. For example, if a nonresident individual with a tax home in the United States sells stocks or other securities for a gain, the individual will be treated as a U.S. resident with respect to the sale such that the gain will be treated as U.S.-source income potentially subject to U.S. tax.

In addition, if a nonresident individual maintains an office or other fixed place of business in the United States, income from the sale of personal property (including inventory property) attributable to such office or place of business is sourced in the United States (sec. 865(e)(2)(A)). If treated as U.S.-source income, the income would be subject to U.S. tax if treated as effectively connected with a U.S. trade or business. This special rule does not apply, however, in the case of inventory property that is sold by the foreign person for use, disposition, or consumption outside the United States if an office or other fixed place of business of such person outside the United States materially participated in the sale (sec. 865(e)(2)(B)).

Moreover, under section 871(a)(2), a nonresident individual who is physically present in the United States for 183 days or more during a taxable year is subject to a 30-percent tax on the excess of U.S.-source capital gains over U.S.-source capital losses. This 30-percent tax is not a withholding tax. The tax under section 871(a)(2) does not apply to gains and losses subject to the gross 30-percent withholding tax under section 871(a)(1) or to gains effectively connected with a U.S. trade or business. Capital gains and losses are taken into account only to the extent that they would be recognized and taken into account if such gains and losses were effectively connected with a U.S. trade or business. Capital loss carryovers are not taken into account.

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[23] Nonresident individuals are subject to the 30-percent gross withholding tax, for example, with respect to gains from the sale or exchange of intangible property if the payments are contingent on the productivity, use, or disposition of the property. Secs. 871(a)(1)(D) and 881(a)(4).

Residency rules

In general, an individual is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident, or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time -- 183 or more days during a three-year period weighted toward the present year (the "substantial presence test") (sec. 7701(b)). An individual meets the 183-day part of the substantial presence test if the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year, equals or exceeds 183 days.[24]

An exception from being treated as a U.S. resident under the substantial presence test applies if (1) the individual is present in the United States for fewer than 183 days during the current calendar year, and (2) the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year.

In general, an individual is treated as being present in the United States on any day if the individual is physically present in the United States at any time during such day. For purposes of the substantial presence test, an individual is not treated as present in the United States on any day during which (1) the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico, (2) the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, or (3) the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession.

In addition, for purposes of the substantial presence test, any days that an individual is present in the United States as an "exempt individual" are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence in the United States of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of "tie-breaker" rules to determine the individual's country of residence for income tax purposes. For example, under these treaties a dual resident individual will be deemed to be a resident of the country in which he or she has a permanent home.

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[24] Presence for 122 days (or more) per year over the three-year period would be sufficient to trigger the substantial presence test.

Applicability of special capital gains tax

The special rule under section 871(a)(2) can apply only in a very limited set of cases. The rule imposes a 30-percent tax on the net U.S.-source capital gains of nonresident individuals who are not citizens and who are physically present in the United States for 183 days or more. Thus, in order for the rule to apply, two conditions must be satisfied: (1) the individual must spend at least 183 days in the United States during a taxable year without being treated as a U.S. resident, and (2) the individual's capital gains must be from U.S. sources. If these conditions are satisfied, then the 30-percent tax applies to the excess of U.S.-source capital gains over U.S.-source capital losses. However, section 871(a)(2) generally is not applicable because if the individual spends 183 days or more in the United States in most cases he or she would be treated as a U.S. resident, or if not treated as a U.S. resident, would generally not have U.S.-source capital gains.

An individual who is not a citizen and who spends 183 days or more in the United States during a calendar year generally would be treated as a U.S. resident under the substantial presence test of section 7701(b). Thus, in most cases, the individual who spends at least 183 days in the United States would not be subject to section 871(a)(2).[25] However, under the substantial presence test under section 7701(b), certain days of physical presence in the United States are not counted for purposes of meeting the 183-day rule. This includes days spent in the United States in which the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico; the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours; the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession; and certain exempt individuals. These exceptions from counting physical presence in the United States do not apply, however, for purposes of the special rule under section 871(a)(2). Thus, it is possible in certain cases for an individual to be present in the United States for at least 183 days without being treated as a U.S. resident under the substantial presence test of section 7701(b).[26]

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[25] *See* the American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 112-113 (1987) (recommending that sec. 871(a)(2) be eliminated and stating "[u]nder Section 7701(b), enacted in 1984, an individual physically present in the U.S. for 183 days in a calendar year is considered a resident, taxable at net income rates on all of his income; and accordingly the justification for Section 871(a)(2) no longer exists." [footnotes omitted]).

[26] It should be noted that there also is a difference with respect to the year over which the 183-day rule is measured for purposes of the substantial presence test and the rule under sec. 871(a)(2). The sec. 871(a)(2) tax applies to 183 days or more of presence in the United States during the taxable year, while the substantial presence test under sec. 7701(b) applies to 183 days or more of presence in the United States during the calendar year. In most cases, however, a nonresident individual's taxable year is his or her calendar year. Secs. 7701(b)(9) and 871(a)(2).

Even if an individual spends at least 183 days in the United States but is not treated as a U.S. resident under section 7701(b), the nonresident individual's capital gains generally will be treated as foreign-source income and, thus, not subject to section 871(a)(2). In this regard, capital gains generally are from foreign sources if the individual is a nonresident, and from U.S. sources if the individual is a U.S. resident. Under a special rule, an individual is treated as a U.S. resident for sales of personal property (including sales giving rise to capital gains) if the individual has a tax home in the United States. This rule applies even if the individual is treated as a nonresident for other U.S. tax purposes. An individual's capital gains would be treated as U.S.-source income and potentially subject to section 871(a)(2) if the individual is treated as a U.S. resident under this special rule.[27]

Even in the limited cases in which the special rule under section 871(a)(2) could potentially apply, a tax treaty might prevent its application.[28]

Description of Proposal

The proposal repeals the special tax on certain capital gains of nonresident aliens under section 871(a)(2).

Effective Date

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

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[27] The individual's income also could be treated as U.S.-source income under sec. 865(e)(2) if the individual derives income from the sale of personal property that is attributable to an office or other fixed place of business that the individual maintains in the United States. However, sec. 871(a)(2) would not apply if the income is effectively connected with a U.S. trade or business, or if the sale qualifies for the exception from U.S.-source treatment as a result of a material participation in the sale by a foreign office of the taxpayer.

[28] Under Article 13(5) of the U.S. model income tax treaty, subject to certain exceptions, the capital gains of a nonresident individual are exempt from U.S. taxation.

III. ADDITIONAL PROVISIONS

A. Proposals Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine

<u>Present Law</u>

<u>In general</u>

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[29]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[30]

<u>Economic substance doctrine</u>

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction.

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[29] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[30] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine". *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[31]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[32]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.[33] A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[34] A third approach regards economic substance and business purpose as "simply

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[31] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[32] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[33] *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.")

[34] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test).") As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of*

more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[35]

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[36] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[37] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[38] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

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the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters) (JCS-3-99) at 182.

[35] *See, e.g., ACM Partnership v. Commissioner,* 157 F.3d at 247; *James v. Commissioner,* 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner,* 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider.... We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[36] *See, e.g., Knetsch,* 364 U.S. at 361; *Goldstein v. Commissioner,* 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner,* 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

[37] *See, e.g., Goldstein v. Commissioner,* 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner,* 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[38] *See, e.g., Rice's Toyota World v. Commissioner,* 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner,* 277 F.3d at 781 (applied the same test, *citing Rice's Toyota World*); *IES Industries v. United States,* 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

Description of Proposal

In general

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[39]

The proposal does not change current law standards used by courts in determining when to utilize an economic substance analysis.[40] Also, the proposal does not alter the court's ability to aggregate or disaggregate a transaction when applying the doctrine. The proposal provides a uniform definition of economic substance, but does not alter court flexibility in other respects.

Conjunctive analysis

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-tax business purpose

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a

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[39] If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this proposal.

[40] *See, e.g.*, Treas. Reg. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[41]

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[42] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[43] should not

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[41] *See, e.g.*, Treas. reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters,* 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse,* 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

[42] However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

[43] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[44]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the proposal reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[45]

Profit potential

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[46] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

Transactions with tax-indifferent parties

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated

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[44] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

[45] *See, e.g., ACM Partnership v. Commissioner,* 157 F.3d at 256 n.48.

[46] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of this proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the proposal shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and this proposal shall be construed as being additive to any such other doctrine.

Effective Date

The proposal applies to transactions entered into after the date of enactment.

2. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[47]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[48] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[49]

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[47] On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

[48] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

[49] Treas. Reg. sec. 1.6011-4(b)(2).

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[50]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[51]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[52]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[53] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[54]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[55]

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

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[50] Treas. Reg. sec. 1.6011-4(b)(3).

[51] Treas. Reg. sec. 1.6011-4(b)(4).

[52] Treas. Reg. sec. 1.6011-4(b)(5). IRS Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

[53] The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $250 million or more in gross assets.

[54] Treas. Reg. sec. 1.6011-4(b)(6). IRS Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

[55] Treas. Reg. sec. 1.6011-4(b)(7).

tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[56]

Description of Proposal

In general

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The proposal does not define the terms "listed transaction"[57] or "reportable transaction," nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a

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[56] 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. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

[57] The proposal states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,[58] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

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

3. 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.[59] 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

[58] A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

[59] Sec. 6662.

treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[60]

Special rules apply with respect to tax shelters.[61] 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.[62] 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.[63]

Description of Proposal

In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[64] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was

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

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

[62] Sec. 6664(c).

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

[64] The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

In addition, a public entity that is required to pay the 30 percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return)[65], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

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[65] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

Strengthened reasonable cause exception

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[66] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[67] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[68] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the

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[66] *See* the previous discussion regarding the penalty for failing to disclose a reportable transaction.

[67] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[68] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[69] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement upon which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this proposal shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

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

4. Penalty for understatements from transactions lacking economic substance

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any

[69] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

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

Special rules apply with respect to tax shelters.[71] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[72] 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.[73]

Description of Proposal

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[74] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance

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[70] Sec. 6662.

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

[72] Sec. 6664(c).

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

[74] Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this proposal applies to any transaction that lacks economic substance.

doctrine),[75] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier proposal regarding the economic substance doctrine),[76] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this proposal, the calculation of an "understatement" is made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[77] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

A public entity that is required to pay a penalty under this proposal (regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Prior to this penalty being asserted in the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals (e.g., a

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[75] The proposal provides that a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

[76] The proposal provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

[77] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

Revenue Agent Report), the IRS Chief Counsel or his delegate at the IRS National Office must approve the inclusion in writing. Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Any understatement to which a penalty is imposed under this proposal will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under this proposal would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under this proposal will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The proposal applies to transactions entered into after the date of enactment.

5. 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).[78]

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, 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.[79]

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

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

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.[80]

Description of Proposal

Definition of substantial understatement

The proposal modifies the definition of "substantial" for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.

Reduction of understatement for certain positions

The proposal elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective Date

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

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

Present Law

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

Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt

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

entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality proposal of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

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

7. 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.[81] A "tax shelter" means any investment with respect to which the tax shelter ratio[82] 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).[83]

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.[84]

In general, a transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[85] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the

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[81] Sec. 6111(a).

[82] 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.

[83] Sec. 6111(c).

[84] Sec. 6111(d).

[85] Treas. Reg. sec. 301.6111-2(b)(2).

arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[86] Certain exceptions are provided with respect to the second category of transactions.[87]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[88]

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

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

Description of Proposal

Disclosure of reportable transactions by material advisors

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)[90] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

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[86] Treas. Reg. sec. 301.6111-2(b)(3).

[87] Treas. Reg. sec. 301.6111-2(b)(4).

[88] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

[89] Sec. 6707.

[90] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[91]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[92] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.[93] All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and

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[91] *See* the previous discussion regarding the disclosure requirements under new section 6707A.

[92] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

[93] The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

Effective Date

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

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

8. Investor lists and modification of penalty for failure to maintain investor lists

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[94] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[95] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[96]

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[97] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if

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[94] Sec. 6112.

[95] Treas. Reg. sec. 301-6112-1.

[96] A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

[97] Treas. Reg. sec. 301.6112-1(c)(1).

all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[98] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[99]

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.[100]

Penalty for failing to maintain investor lists

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

Description of Proposal

Investor lists

Each material advisor[101] with respect to a reportable transaction (including a listed transaction)[102] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

The proposal also clarifies that, for purposes of section 6112, the identity of any person is not privileged under the common law attorney-client privilege (or, consequently, the section 7525 federally authorized tax practitioner confidentiality provision).

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[98] Treas. Reg. sec. 301.6112-1(c)(2) and (3).

[99] Treas. Reg. sec. 301.6112-1(b).

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

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

[102] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[103]

Effective Date

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

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

The proposal clarifying that the identity of any person is not privileged for purposes of section 6112 is effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

9. Actions to enjoin conduct with respect to tax shelters and reportable transactions

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[104]

Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[105] and the keeping of lists of investors by material advisors.[106] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

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[103] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

[104] Sec. 7408.

[105] Sec. 6707, as amended by other proposals of this bill.

[106] Sec. 6708, as amended by other proposals of this bill.

Effective Date

The proposal is effective on the day after the date of enactment.

10. 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 such a return is liable for a penalty of $1,000.

Description of Proposal

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

In addition, the proposal increases 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 is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

Effective Date

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

11. Penalty for failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[107] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

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[107] 31 U.S.C. 5314.

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.[108] 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.[109]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[110] This report, which was statutorily required,[111] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

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

Effective Date

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

12. 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[112] to

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[108] 31 U.S.C. 5321(a)(5).

[109] 31 U.S.C. 5322.

[110] *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.

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

[112] 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.

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 modifies the IRS-imposed penalty by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this proposal applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal permits the IRS to dismiss such requests. Second, the proposal permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these proposals.

Effective Date

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

13. 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.[113] 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 makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition

[113] 31 U.S.C. 330.

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

Effective Date

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

14. 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.[114] 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 modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

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[114] Sec. 6700.

Effective Date

The proposal is effective for activities after the date of enactment.

15. Extend statute of limitations for certain undisclosed transactions

Present Law

In general, the Code requires that taxes be assessed within three years[115] after the date a return is filed.[116] If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[117] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[118]

Description of Proposal

The proposal extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[119] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject to the extended statute of limitations.[120]

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[115] Sec. 6501(a).

[116] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[117] Sec. 6501(e).

[118] Sec. 6501(c).

[119] The term "listed transaction" has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

[120] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this proposal does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are

Effective Date

The proposal is effective for taxable years with respect to which the period for assessing a deficiency did not expire before October 1, 2003.

16. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[121] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.[122]

Effective Date

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

17. Authorize additional $300 million per year to the IRS to combat abusive tax avoidance transactions

Present Law

There is no explicit authorization of appropriations to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

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recognized over multiple tax years, the proposal's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

[121] Sec. 163(a).

[122] The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions and the proposal to impose a penalty on understatements attributable to transactions that lack economic substance.

Description of Proposal

The proposal includes an authorization of an additional $300 million to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

Effective Date

The proposal is effective on the date of enactment.

B. Other Corporate Governance Proposals

1. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[123]

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.[124]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[125]

In the recent case of *Rite Aid Corp. v. United States*,[126] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

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[123] Sec. 1501.

[124] Sec. 1502.

[125] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15 (1928), describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v. United States*, 1 Ct. Cl. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied*, 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

[126] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.[127] The particular provision, known as the "duplicated loss" provision,[128] 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.[129]

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[127] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States,* 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra. see also Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation*, 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term "taxable year."

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

[129] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate

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.[130]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[131] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [132]

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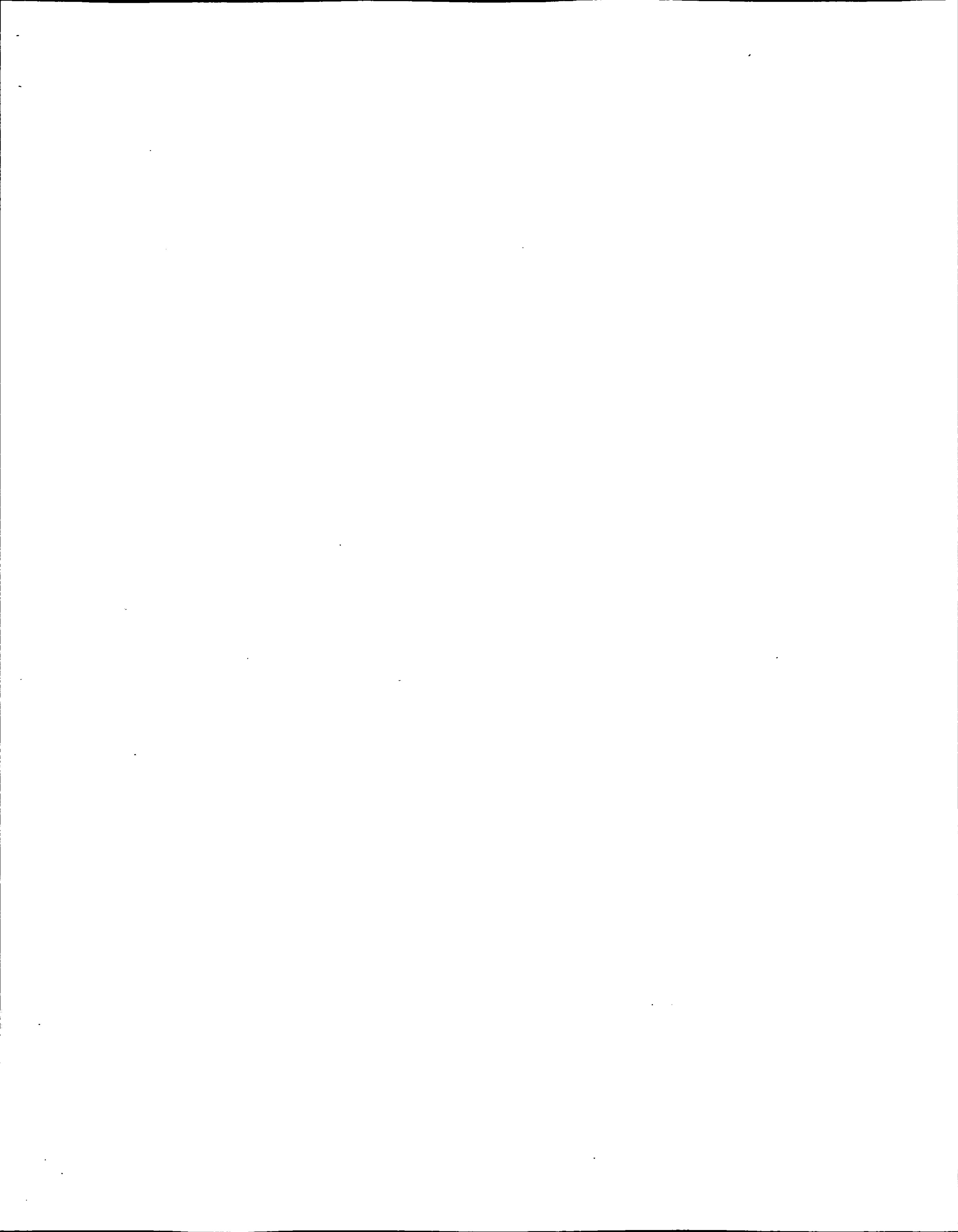
between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[130] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[131] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[132] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate



The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[133]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[134]

Description of Proposal

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined

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returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[133] *Rite Aid*, 255 F.3d at 1360.

[134] *See* Temp. Reg. Sec. 1.1502-20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); and T.D. 9048, 68 F.R. 12287 (March 14, 2003).

and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[135] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[136]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[137]

Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is intended that the results following from the proposal are not the same as the results under present law.

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

[136] The proposal is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

[137] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

2. Chief executive officer required to sign declaration as part of corporate income tax return

Present Law

The Code requires[138] that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes[139] a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than $100,000[140] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

Description of Proposal

The proposal requires that the chief executive officer of a corporation sign a declaration under penalties of perjury that the corporation's income tax return complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. This declaration is part of the income tax return. The proposal is in addition to the requirement of present law as to the signing of the income tax return itself. Because a CEO's duties generally do not require a detailed or technical understanding of the corporation's tax return, it is anticipated that this declaration of the CEO will be more limited in scope than the declaration of the officer required to sign the return itself.

The Secretary of the Treasury shall prescribe the matters to which the declaration of the CEO applies. It is intended that the declaration help insure that the preparation and completion of the corporation's tax return be given an appropriate level of care. For example, it is anticipated that the CEO would declare that processes and procedures have been implemented to ensure that the return complies with the Internal Revenue Code and all regulations and rules promulgated thereunder. Although appropriate processes and procedures can vary for each taxpayer depending on the size and nature of the taxpayer's business, in every case the CEO should be briefed on all material aspects of the corporation's tax return by the corporation's chief financial officer (or another person authorized to sign the return under present law).

It is also anticipated that, as part of the declaration, the CEO would certify that, to the best of the CEO's knowledge and belief: (1) the processes and procedures for ensuring that the corporation files a tax return that complies with the requirements of the Code are operating

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[138] Sec. 6062.

[139] Sec. 7206.

[140] Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is $250,000.

effectively; (2) the return is true, accurate, and complete; (3) the officer signing the return did so under no compulsion to adopt any tax position with which that person did not agree; (4) the CEO was briefed on all listed transactions as well as all reportable transactions otherwise required to be disclosed on the tax return; and (5) all required disclosures have been filed with the return. The Secretary may by regulations prescribe additional requirements for this declaration.[141]

If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the declaration. It is intended that the IRS issue general guidance, such as a revenue procedure, to: (1) address situations when a corporation does not have a chief executive officer; and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title or when a corporation has multiple chief executive officers. It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign this declaration.

The proposal does not apply to the income tax returns of mutual funds;[142] they are required to be signed as under present law.

Effective Date

The proposal is effective for returns filed after the date of enactment.

3. Denial of deduction for certain fines, penalties, and other amounts

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[143]

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation

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[141] Sec. 6011(a).

[142] The proposal does, however, apply to the income tax returns of mutual fund management companies and advisors.

[143] S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Description of Proposal

The proposal modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the proposal generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible under any provision of the income tax provisions.[144] The proposal applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.[145]

It is intended that a payment will be treated as restitution only if the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.[146] Restitution is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are subject to the proposal. To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are also subject to the provision.

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[144] The proposal provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[145] The proposal does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

[146] Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the proposal, such a payment not deductible under section 162 would also not be deductible under section 170.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the proposal is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective Date

The proposal is effective for amounts paid or incurred on or after April 28, 2003; however the proposal does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained on or before April 27, 2003.

4. Denial of deduction for punitive damages

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[147] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[148] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[149] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[150]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[151] However, this exclusion does not apply to punitive damages.[152]

Description of Proposal

The proposal denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in

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[147] Sec. 162(a).

[148] Sec. 162(c).

[149] Sec. 162(f).

[150] Sec. 162(g).

[151] Sec. 104(a).

[152] Sec. 104(a)(2).

gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective Date

The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

5. Criminal tax fraud

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[153] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine

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[153] Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

Description of Proposal

Attempt to evade or defeat tax

The proposal increases the criminal penalty under section 7201 of the Code for individuals to $250,000 and for corporations to $1,000,000. The proposal increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The proposal increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

Fraud and false statements

The proposal increases the criminal penalty under section 7206 of the Code for individuals to $250,000 and for corporations to $1,000,000. The proposal increases the maximum prison sentence to five years. The proposal also provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective Date

The proposal is effective for offenses committed after the date of enactment.

C. Enron-Related Tax Shelter Proposals

1. Limitation on transfer and importation of built-in losses

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[154] The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[155]

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.[156]

Description of Proposal

Importation of built-in losses

The proposal provides that if a net built-in loss is imported into the U.S in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the proposal, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceeds the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U. S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if the properties had been transferred by each of the partners in proportion to their interests in the partnership.

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[154] Sec. 351.

[155] Sec. 358.

[156] Secs. 334(b) and 362(a) and (b).

Limitation on transfer of built-in-losses in section 351 transactions

The provision provides that if the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property. Under the provision, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. In the case of a transfer after which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation, any basis reduction required by the provision is made to the stock received by the transferor and not to the assets transferred.

Effective Date

The proposal applies to transactions after February 13, 2003.

2. No reduction of basis under section 734 in stock held by partnership in corporate partner

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to a partnership.[157] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[158] This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[159] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of

[157] Sec. 721(a).

[158] Sec. 731(a) and (b).

[159] Sec. 732(b).

partnership property in the case of a distribution of partnership property.[160] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[161] In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[162]

Description of Proposal

The proposal provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the proposal, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective Date

The proposal applies to distributions after February 13, 2003.

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[160] Sec. 754.

[161] Sec. 755(a).

[162] Sec. 755(b).

3. Repeal of special rules for FASITs

Present Law

Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.[163] A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[164] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

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[163] Sections 860H through 860L.

[164] Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

"Regular interests" of a FASIT

"Regular interests" of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest", an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT's owner (or a person related to the FASIT's owner), the property is treated as being first acquired by the FASIT's owner for the FASIT's cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules.–In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

Real estate mortgage investment conduits

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[165] In order to qualify as a REMIC, substantially all of the assets of the entity must consist of

[165] *See* sections 860A through 860G.

qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

Original issue discount accruals with respect to debt instruments and pools of debt instruments subject to acceleration of principal payment

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.[166] In general, issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments and pools of instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a REMIC or qualified mortgage held by a REMIC, (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, or (3) any pool of debt instruments the yield on which may be affected by reason of

[166] The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

prepayments, the daily portions of the OID on such debt instruments and pools of debt instruments generally are determined by taking into account an assumption regarding the prepayment of principal for such instruments. The prepayment assumption to be used for this purpose is that which the parties use in pricing the particular transaction.

Description of Proposal

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the proposal also modifies the definitions of qualified mortgages, permitted investments, and regular interests so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. In addition, the proposal modifies the OID rules with respect to certain instruments and pools of instruments that may be subject to principal prepayment so that the prepayment assumption used in determining the daily portions of the OID on such debt instruments and pools of debt instruments for an accrual period is a current prepayment assumption determined as of the close of such accrual period in the manner prescribed by regulations.

Effective Date

Except as provided by the transition period for existing FASITs, the proposal is effective after February 13, 2003.

4. Expanded disallowance of deduction for interest on convertible debt

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Under present law, no deduction is allowed for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or

convertible at the issuer's option into equity of the issuer or a related party.[167] In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of equity of the issuer or related party.[168] A debt instrument also is treated as payable in equity if it is part of an arrangement that is designed to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that option will be exercised.[169]

Description of Proposal

The proposal expands the present-law disallowance of interest deductions on certain corporate debt that is payable in, or by reference to the value of, equity. Under the proposal, the disallowance includes interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or any related party) in any other person, without regard to whether such equity represents more than a 50-percent ownership interest in such person. The basis of such equity is increased by the amount of interest deductions that is disallowed by the proposal. The proposal directs the Treasury Department to issue regulations that provide rules for determining the manner in which the basis of equity held by the issuer (or related party) is increased by the amount of interest deductions that is disallowed under the proposal.

The proposal does not apply to debt that is issued by an active dealer in securities (or a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

Effective Date

This proposal applies to debt instruments that are issued after February 13, 2003.

5. Expanded authority to disallow tax benefits under section 269

Present Law

Section 269 provides that if a taxpayer acquires, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary may disallow the

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[167] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

[168] Sec. 163(l)(3)(B).

[169] Sec. 163(l)(3)(C).

such tax benefits.[170] Similarly, if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately before the acquisition), the basis of such property is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing a tax benefit that would not otherwise have been available, the Secretary may disallow such tax benefits.[171]

Description of Proposal

The proposal expands section 269 by repealing the requirement that the acquisition of property be from a corporation not controlled by the acquirer. Thus, under the proposal, section 269 disallows the tax benefits of (1) any acquisition of stock sufficient to obtain control of a corporation,[172] and (2) any acquisition by a corporation of property from a corporation in which the basis of such property is determined by reference to the basis in the hands of the transferor corporation, if the principal purpose of such acquisition is the evasion or avoidance of Federal income tax.

Effective Date

The proposal applies to property acquired after February 13, 2003.

6. Modification of CFC-PFIC coordination rules

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[173] and the passive foreign investment company rules.[174] Deferral of U.S. tax is considered appropriate, on the other hand, with respect

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[170] Sec. 269(a)(1).

[171] Sec. 269(a)(2).

[172] In this regard, the proposal applies regardless of whether an acquisition results in an increase in the acquiror's ownership percentage in a corporation or involves the issuance of actual stock certificates or shares by a corporation to the acquiror.

[173] Secs. 951-964.

[174] Secs. 1291-1298.

to most types of active business income earned abroad. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[175]

Subpart F,[176] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[177] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[178]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[179] insurance income,[180] and certain income relating to international boycotts and other violations of public policy.[181] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[182]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[183]

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

[176] Secs. 951-964.

[177] Secs. 951(b), 957, 958.

[178] Sec. 951(a).

[179] Sec. 954.

[180] Sec. 953.

[181] Sec. 952(a)(3)-(5).

[182] Sec. 954.

[183] Secs. 951(a)(1)(B), 956.

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[184] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[185] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[186] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[187]

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation's subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S. shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

Description of Proposal

The proposal adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

[184] Sec. 1297.

[185] Sec. 1293-1295.

[186] Sec. 1291.

[187] Sec. 1296.

Effective Date

The proposal is effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

D. Tax Treatment of Inversion Transactions

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[188] and the passive foreign investment company rules.[189] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such

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[188] Secs. 951-964.

[189] Secs. 1291-1298.

"effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

Under present law, U.S. corporations may reincorporate in foreign jurisdictions and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as "inversion" transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various "earnings stripping" or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain 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 Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under sections 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Description of Proposal

In general

The proposal defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[190] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The proposal denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[191]

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[190] It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

[191] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated

Except as otherwise provided in regulations, the proposal does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in a public offering (whether initial or secondary) or private placement related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the proposal is met with respect to such corporation or partnership.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person, a member of an expanded affiliated group, or a publicly traded corporation. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the IRS is given expanded authority 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, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable,

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investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.

without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

In order to enhance IRS monitoring of related-party transactions, the proposal establishes a new pre-filing procedure. Under this procedure, the taxpayer will 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 163(j), 267(a)(3), 482, and 845. The Treasury Secretary is 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 will 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 will apply for the taxable year for which the application was required: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties will be permitted; (2) any transfers or licenses of intangible property to related foreign parties will be disregarded; and (3) any cost-sharing arrangements will not be respected. In such a case, the taxpayer may seek direct review by the U.S. Tax Court of the IRS's determination of compliance failure.

If the IRS fails to act on the taxpayer's application within 90 days of receipt, then the taxpayer will be treated as having submitted in good faith an application that substantially complies with the above-referenced requirements. Thus, the deduction disallowance and other sanctions described above will not apply, but the IRS will be able to examine the transactions at issue under the normal audit process. The IRS is 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, are strengthened for inverted corporations. With respect to such corporations, the proposal eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or

assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Partnership transactions

Under the proposal, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the proposal apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership (whether or not publicly traded), if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

E. Proposal to Impose Mark-to-Market Tax on Individuals Who Expatriate

Present Law

In general

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign-source income. Nonresidents who are not U.S. citizens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business.

Income tax rules with respect to expatriates

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the expatriation or residency termination under section 877. The alternative method of taxation for expatriates modifies the rules generally applicable to the taxation of nonresident noncitizens in several ways. First, the individual is subject to tax on his or her U.S.-source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident noncitizens. Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign-source income. Second, the scope of items treated as U.S.-source income for section 877 purposes is broader than those items generally considered to be U.S.-source income under the Code.[192] Third, individuals subject to section 877 are taxed on exchanges of certain types of property that give rise to U.S.-source income for property that gives rise to foreign-source income.[193] Fourth, an individual subject to section 877 who contributes property to a controlled foreign corporation is treated as receiving income or gain from such property directly and is taxable on such income or gain. The alternative method of taxation for expatriates applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident noncitizen.

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[192] For example, gains on the sale or exchange of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S.-source income under the Code. Thus, such gains would not be taxable to a nonresident noncitizen. However, if an individual is subject to the alternative regime under sec. 877, such gains are treated as U.S.-source income with respect to that individual.

[193] For example, a former citizen who is subject to the alternative tax regime and who removes appreciated artwork that he or she owns from the United States could be subject to immediate U.S. tax on the appreciation. In this regard, the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of $250,000 within the 15-year period beginning five years prior to the expatriation will be treated as an "exchange" subject to these rules.

The expatriation tax provisions apply to long-term residents of the United States whose U.S. residency is terminated. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty).

Subject to the exceptions described below, an individual is treated as having expatriated or terminated residency with a principal purpose of avoiding U.S. taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of the individual's loss of U.S. citizenship or termination of U.S. residency is greater than $100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is $500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. An individual who falls below these thresholds is not automatically treated as having a principal purpose of tax avoidance, but nevertheless is subject to the expatriation tax provisions if the individual's loss of citizenship or termination of residency in fact did have as one of its principal purposes the avoidance of tax.

Certain exceptions from the treatment that an individual relinquished his or her U.S. citizenship or terminated his or her U.S. residency for tax avoidance purposes may also apply. For example, a U.S. citizen who loses his or her citizenship and who satisfies either the tax liability test or the net worth test (described above) can avoid being deemed to have a principal purpose of tax avoidance if the individual falls within certain categories (such as being a dual citizen) and the individual, within one year from the date of loss of citizenship, submits a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes.

<u>Estate tax rules with respect to expatriates</u>

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.[194] Such property includes real estate and tangible property located within the United States. Moreover, for estate tax purposes, stock held by nonresident noncitizens is treated as U.S.-situated if issued by a U.S. corporation.

Special rules apply to U.S. citizens who relinquish their citizenship and long-term residents who terminate their U.S. residency within the 10 years prior to the date of death, unless the loss of status did not have as one its principal purposes the avoidance of tax (sec. 2107). Under these rules, the decedent's estate includes the proportion of the decedent's stock in a

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

foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation. This rule applies only if (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.

Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Gift tax rules with respect to expatriates

Nonresident noncitizens generally are subject to gift tax on certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Unlike the estate tax rules for U.S. stock held by nonresidents, however, nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Special rules apply to U.S. citizens who relinquish their U.S. citizenship or long-term residents of the United States who terminate their U.S. residency within the 10 years prior to the date of transfer, unless such loss did not have as one of its principal purposes the avoidance of tax (sec. 2501(a)(3)). Under these rules, nonresident noncitizens are subject to gift tax on transfers of intangibles, such as stock or securities. Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Other tax rules with respect to expatriates

The expatriation tax provisions permit a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate, or similar taxes paid with respect to the items subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability.

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least $500,000, and such other information as the Secretary may prescribe. The information statement must be provided no later than the earliest day on which the individual (1) renounces the individual's U.S. nationality before a diplomatic or

consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is canceled by a U.S. court. The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) $1,000.

The State Department is required to provide the Secretary of the Treasury with a copy of each certificate of loss of nationality approved by the State Department. Similarly, the agency administering the immigration laws is required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned. Further, the Secretary of the Treasury is required to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or certificates of loss of nationality it receives under the foregoing information-sharing provisions.

Immigration rules with respect to expatriates

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.

Description of Proposal

In general

The proposal generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2003.

Individuals covered

Under the proposal, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term

resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Election to be treated as a U.S. citizen

Under the proposal, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

Date of relinquishment of citizenship

Under the proposal, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of

U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon expatriation or residency termination

The deemed sale rule of the proposal generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the proposal. Regulatory authority is granted to the Treasury to except other types of property from the proposal.

Under the proposal, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Retirement plans and similar arrangements

Subject to certain exceptions, the proposal applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[195] However, the proposal contains a special rule for an interest in a "qualified retirement plan." For purposes of the proposal, a "qualified retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may

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[195] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the proposal, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

Deferral of payment of tax

Under the proposal, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

Interests in trusts

Under the proposal, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these proposals. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.–If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.–If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax

amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after February 5, 2003.

Treatment of gifts and inheritances from a former citizen or former long-term resident

Under the proposal, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then

take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Information reporting

The proposal provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the proposal.

Immigration rules

The proposal amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the proposal's expatriation tax proposals (regardless of the subjective motive for expatriating). For this purpose, the proposal permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the proposal would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this proposal.

Effective Date

The proposal generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after February 5, 2003. The proposals relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after February 5, 2003, whose expatriation or residency termination occurs on or after such date. The proposals relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

F. Other Revenue Proposals

1. Effectively connected income to include certain foreign source income

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[196] Foreign persons also are subject to a 30-percent gross-basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[197] The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a U.S. trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income (sometimes referred to as the "force of attraction rule").

In general, foreign-source income is not treated as U.S.-effectively connected income.[198] However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories described below.[199] For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.[200]

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[196] Sections 871(b) and 882.

[197] Section 864(c).

[198] Section 864(c)(4).

[199] Section 864(c)(4)(B).

[200] Section 864(c)(5).

The first category consists of rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business.[201] The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.[202] Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock.[203] The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business.[204] Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale or exchange.

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties, and personal services income.[205] For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules.[206] In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected with a U.S. trade or business.[207] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient

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[201] Section 864(c)(4)(B)(i).

[202] Section 864(c)(4)(B)(ii).

[203] Section 864(c)(4)(D)(i).

[204] Section 864(c)(4)(B)(iii).

[205] Sections 861 through 865.

[206] See *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982).

[207] Treas. Reg. sec. 1.864-5(b)(2)(ii).

of the income, but is treated as U.S.-source effectively connected income if it arises from the conduct of a United States trade or business.[208]

Description of Proposal

Under the proposal, each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents are treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Effective date

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

2. Recapture of overall foreign losses on sale of controlled foreign corporation stock

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to the portion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) bears to the taxpayer's worldwide taxable income for the year.[209] Separate limitations are applied to specific categories of income.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation.[210] Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income.[211] The amount resourced as

[208] Treas. Reg. sec. 1.863-7(b)(3).

[209] Section 904(a).

[210] Section 904(f).

[211] Section 904(f)(1).

U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured.[212] In this regard, dispositions of trade or business property used predominantly outside the United States are treated as having been recognized as foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such income would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[213]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income).[214] Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock, for purposes of the interest apportionment.

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[212] Section 904(f)(3).

[213] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Section 367(a)(3)(C).

[214] Section 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

Description of Proposal

Under the proposal, the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets is to apply to the disposition of controlled foreign corporation stock. Thus, dispositions of controlled foreign corporation stock are recognized as foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income is resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Effective date

The proposal is effective as of the date of enactment.

3. Disallowance of certain partnership loss transfers

Present Law

Contributions of property

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[215] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[216] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[217] Any items of partnership income, gain, loss and deduction with respect to the contributed property is allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[218] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.[219]

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.[220]

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[215] Sec. 721.

[216] Sec. 723.

[217] Sec. 722.

[218] Sec. 704(c)(1)(A).

[219] If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for reasonable allocations to remedy this insufficiency. Treas. Reg. sec. 1.704-3(c) and (d).

[220] Treas. Reg. 1.704-3(a)(7).

If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[221] If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[222] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[223] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[224] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[225]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[226] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by

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[221] Sec. 743(a).

[222] Sec. 743(b).

[223] Sec. 731(a) and (b).

[224] Sec. 732(b).

[225] Sec. 732(a).

[226] Sec. 734(a).

the distributee partner).[227] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Description of Proposal

Contributions of property

Under the proposal, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[228]

Transfers of partnership interests

The proposal provides that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the proposal, section 743(b) applies, so that a $300,000 decrease is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

Distribution of partnership property

The proposal provides that the a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial

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[227] Sec. 734(b).

[228] It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

basis reduction means a downward adjustment of more that $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million, and that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C's hands is $5 million. Under present law, C would recognize a loss of $4 million if the LMN stock were sold for $1 million.

Under the proposal, however, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than $250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by $2 million (the amount by which the basis LMN stock was increased), leaving a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million.

Effective Date

The proposal applies to contributions, transfers, and distributions (as the case may be) after the date of enactment.

4. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[229]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed

[229] *Helvering v. Horst*, 311 U.S. 112 (1940).

below).[230] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[231]

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[232] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[233] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[234] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[235] Special rules apply to require

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[230] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[231] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

[232] Sec. 1286.

[233] Sec. 1286(e).

[234] Sec. 1286(a).

[235] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity (or on the due date of the coupons) exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[236]

Stripped preferred stock

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[237] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[238] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[239]

Description of Proposal

The proposal authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The proposal applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

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[236] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[237] Sec. 305(e)(5).

[238] Sec. 305(e)(1).

[239] Sec. 305(e)(3).

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this proposal would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,[240] *modifying and superceding* Rev. Proc. 2002-16.[241]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

Effective Date

The proposal is effective for purchases and dispositions occurring after the date of enactment.

5. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends

Present Law

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

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier

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[240] 2002-43 I.R.B. 753.

[241] 2002-9 I.R.B. 572.

foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

Description of Proposal

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the proposal. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

Effective Date

The proposal is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

6. Modify treatment of transfers to creditors in divisive reorganizations

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a subsidiary tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the corporation ("controlled') that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under section 355 and that are considered 'acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

Description of Proposal

The proposal limits the amount of money or other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the proposal provides that acquisitive reorganizations under section 368(a)(1)(D) are no longer subject to the liabilities assumption rules of section 357(c).

Effective Date

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

7. Extend the present-law intangible amortization provisions to acquisitions of sports franchises

Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[242] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[243] However, other special rules apply to certain of these intangible assets.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[244] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

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[242] Sec. 197.

[243] Sec. 197(e)(6).

[244] *P.D.B. Sports, Ltd. v. Comm'r*, 109 T.C. 423 (1997).

Description of Proposal

The proposal extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with such a franchise, acquisitions of sports franchises (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises.

Effective Date

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

8. Clarification of rules for payment of estimated tax for certain deemed asset sales

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account. Some taxpayers may be taking the position that this exception applies to a section 338(h)(10) election and that when such an election is made, neither any stock sale nor any asset sale needs to be taken into account for estimated tax purposes.

Description of Proposal

The proposal would clarify section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the proposal, if a transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax would be computed based on an asset sale. If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax would be recomputed based on the asset sale election.

No inference is intended as to present law.

Effective Date

The proposal would be effective for transactions that occur after the date of enactment of the proposal.

9. 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[245] extended the statutory authorization for these user fees[246] through September 30, 2003.

Description of Proposal

The proposal extends the statutory authorization for these user fees through September 30, 2013. The proposal also moves the statutory authorization for these fees into the Code.[247]

Effective Date

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

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[245] 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).

[246] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987).

[247] The proposal also moves into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, June 7, 2001).

10. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related and fraud penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the same statute of limitations.

Delinquency penalties

Failure to file.–Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay.–Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to file tax shown on a return may not reduce the penalty for failure to pay below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax.–The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the day on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

The accuracy-related penalty is imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax and (3) any substantial valuation misstatement. In addition, the penalty is doubled for certain gross valuation misstatements. These consolidated penalties are also coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. However, Treasury has issued proposed regulations that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

Negligence or disregard for the rules or regulations.–If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless or intentional disregard of the rules or regulations.

Substantial understatement of income tax.–Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement.–A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Gross valuation misstatements.–The rate of the accuracy-related penalty is doubled (to 40 percent) in the case of gross valuation misstatements.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Interest Provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. Taxpayers eligible under OVCI will not be liable for civil fraud, the fraudulent failure to file penalty or the civil information return penalties. The taxpayer will pay back taxes, interest and certain accuracy-related and delinquency penalties.

Voluntary Disclosure Initiative

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers

Description of Proposal

The proposal increases the total amount of civil penalties, interest and fines applicable by a factor of two for taxpayers who would have been eligible to participate in either the OVCI or the Treasury Department's voluntary disclosure initiative, which applies to the taxpayer by reason of the taxpayer's underpayment of U.S. income tax liability through certain financing arrangements, but did not participate in either program.

Effective Date

The proposal generally is effective with respect to a taxpayer's open tax years on or after date of enactment.

11. Add vaccines against hepatitis A to the list of taxable vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[248] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal adds any vaccine against hepatitis A to the list of taxable vaccines. The proposal also makes a conforming amendment to the trust fund expenditure purposes.

Effective Date

The proposal is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[249] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence

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[248] sec. 4131

[249] Sec. 121.

for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

Description of Proposal

The proposal provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

Effective date

The proposal is effective for sales or exchanges of principal residences after the date of enactment.

13. Authorize IRS to enter into installment agreements that provide for partial payment

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

Description of Proposal

The proposal clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Effective Date

The proposal is effective for installment agreements entered into on or after the date of enactment.

14. Lease term to include certain service contracts

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[250] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[251] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[252]

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Description of Proposal

The proposal requires lessors of tax-exempt use property to include the term of service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

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[250] Sec. 168(g)(3)(A).

[251] Sec. 168(h)(1).

[252] Sec. 168(h)(2).

Effective Date

The proposal is effective for leases and other similar arrangements entered into after the date of enactment. No inference is intended with respect to the tax treatment of leases and other similar arrangements entered into before such date.

ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S MARK OF S. 1637, THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON OCTOBER 1, 2003

Fiscal Years 2004 - 2013

[Millions of Dollars]

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
Provisions Relating to Repeal of Exclusion for Extraterritorial Income													
1. Repeal of exclusion for extraterritorial income [1]	toa DOE	3,710	4,780	5,093	5,312	5,508	5,727	5,993	6,258	6,518	6,789	24,403	55,688
2. Deduction relating to income attributable to United States production activities	tyea DOE	-339	-835	-1,609	-3,510	-4,340	-4,947	-6,094	-6,300	-7,682	-9,952	-10,633	-45,608
Total of Provisions Relating to Repeal of Exclusion for Extraterritorial Income		**3,371**	**3,945**	**3,484**	**1,802**	**1,168**	**780**	**-101**	**-42**	**-1,164**	**-3,163**	**13,770**	**10,080**
General Transition for Repeal of Exclusion for Extraterritorial Income	**toa DOE & before 2007**	**-3,105**	**-3,234**	**-2,682**	**-765**	**---**	**---**	**---**	**---**	**---**	**---**	**-9,786**	**-9,786**
International Tax Provisions													
A. International Tax Reform													
1. Extend the foreign tax credit carryforward from 5 years to 20 years	[2]	---	-266	-343	-412	-577	-767	-941	-1,080	-1,253	-1,453	-1,598	-7,092
2. Apply look-through rules for dividends from noncontrolled section 902 corporations	tyba 12/31/02	-585	-77	-51	-23	-6	-1	[3]	[3]	[3]	[3]	-742	-743
3. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	---	-236	-355	-338	-334	-333	-334	-338	-344	-352	-1,263	-2,964
4. Recharacterize overall domestic loss	lf tyba 12/31/06	---	---	---	-57	-680	-713	-756	-793	-829	-862	-737	-4,690
5. Interest expense allocation rules	tyba 12/31/09	---	---	---	---	---	---	-963	-2,586	-2,689	-2,797	---	-9,035
6. Determination of foreign personal holding company income with respect to transactions in commodities	teia 12/31/04	---	-4	-10	-10	-10	-10	-11	-11	-11	-11	-34	-88
B. International Tax Simplification													
1. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules	[4]	---	-25	-65	-73	-81	-91	-102	-114	-128	-143	-244	-822
2. Expand the subpart F de minimis rule to the lesser of 5% of gross income or $5 million	[4]	---	-15	-143	-157	-173	-190	-209	-230	-253	-279	-488	-1,649
3. Attribution of stock ownership through partnerships in determining section 902 and 960 credits	tyba DOE	[3]	-1	-3	-3	-3	-3	-3	-3	-3	-3	-10	-25
4. Limit application of uniform capitalization rules in the case of foreign persons	tyba 12/31/04	---	-125	-278	-79	-27	-8	-12	-14	-16	-18	-509	-577
5. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations	pma 12/31/04	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
6. Eliminate 30% tax on certain U.S.-source capital gains of nonresident individuals	tyba 12/31/03	---	-2	-2	-2	-3	-3	-3	-3	-3	-3	-9	-24
Total of International Tax Provisions		-585	-753	-1,253	-1,157	-1,897	-2,122	-3,337	-5,175	-5,532	-5,924	-5,645	-27,735
Interaction	---	13	14	16	17	19	21	245	620	646	674	79	2,285
Additional Provisions													
A. Provisions Designed to Curtail Tax Shelters													
1. Clarification of the economic substance doctrine and related penalty provisions	tela DOE	1,031	1,242	1,163	1,049	1,086	1,200	1,335	1,517	1,729	1,970	5,571	13,322
2. Provisions relating to reportable transactions and tax shelters	various dates after DOE [5]	92	115	119	120	124	131	139	150	164	179	570	1,333
3. Modification to the substantial understatement penalty	tyba DOE	---	4	11	19	23	26	30	34	38	38	57	223
4. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts	DOE	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	1	3
5. Actions to enjoin conduct with respect to tax shelters	DOE	Negligible Revenue Effect											
6. Understatement of taxpayer's liability by income tax return preparer	dpa DOE	Negligible Revenue Effect											
7. Frivolous tax submissions	[7]	3	3	3	3	3	3	3	3	3	3	15	30
8. Regulation of individuals practicing before the Department of Treasury	ata DOE	No Revenue Effect											
9. Extend statute of limitations for undisclosed listed transactions	[8]	---	---	1	1	1	1	1	1	1	1	3	8
10. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions	tyba DOE	---	---	1	1	3	4	4	4	4	4	5	25
11. Authorize additional $300 million per year to the IRS to combat abusive tax avoidance transactions [9]	DOE	No Revenue Effect											
Total of Provisions Designed to Curtail Tax Shelters		1,126	1,364	1,298	1,193	1,240	1,365	1,512	1,709	1,939	2,195	6,222	14,944
B. Other Corporate Governance Provisions													
1. Affirmation of consolidated return regulation authority	[10]	Negligible Revenue Effect											
2. Chief executive officer required to sign declaration as part of corporate income tax return	rfa DOE	Negligible Revenue Effect											
3. Denial of deduction for certain fines, penalties, and other amounts	apoia 4/27/03	101	10	10	10	10	10	10	10	10	10	141	191
4. Denial of deduction for punitive damages	dpoia DOE	38	29	30	31	32	33	34	35	36	37	160	333
5. Criminal tax fraud package	oco/a DOE	---	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	5
Total of Other Corporate Governance Provisions		139	39	40	41	42	43	44	45	46	47	301	529
C. Enron-Related Tax Shelter Provisions													
1. Limitation on transfer or importation of built-in losses	ta 2/13/03	128	123	136	149	164	180	198	218	240	264	700	1,800
2. No reduction of basis under section 734 in stock held by partnership in corporate partner	da 2/13/03	9	13	20	28	36	44	51	54	56	57	105	368
3. Repeal of special rules for FASITs	after 2/13/03	Negligible Revenue Effect											

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
4. Expanded disallowance of deduction for interest on convertible debt	diia 2/13/03	6	88	90	94	96	98	101	103	106	109	374	891
5. Expanded authority to disallow tax benefits under section 269	aa 2/13/03	10	9	9	10	10	11	11	12	12	13	48	108
6. Modification of CFC-PFIC coordination rules	[11]	23	15	8	4	5	6	8	10	12	15	55	106
Total of Enron-Related Tax Shelter Provisions		176	248	263	285	311	339	369	397	426	458	1,282	3,273
D. Tax Treatment of Inversion Transactions	[12]	172	137	140	168	202	242	290	348	418	493	819	2,610
E. Impose Mark-to-Market on Individuals who Expatriate	[13]	101	84	80	74	71	67	61	57	54	51	410	700
F. Other Revenue Provisions													
1. Effectively connected income to include certain foreign-source income	tyba DOE	3	5	7	8	9	10	10	10	10	11	32	83
2. Recapture of overall foreign losses on sale of controlled foreign corporation stock	DOE	[6]	3	7	8	9	9	9	10	10	10	27	75
3. Disallowance of partnership loss transfers	ctada DOE	15	39	57	70	79	84	86	89	91	94	261	705
4. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds	padoa DOE	2	13	11	8	5	3	[6]	[6]	[6]	[6]	39	42
5. Minimum holding period for foreign tax credit on withholding tax on income other than dividends	apoamt30da DOE	[6]	3	3	3	3	4	4	4	4	5	12	33
6. Modify treatment of transfers to creditors in divisive reorganizations	to/a DOE	[6]	8	9	10	10	10	11	11	12	12	37	93
7. Extend present-law intangibles amortization provisions to acquisitions of sports franchises	aoa DOE	13	61	94	68	36	23	21	19	22	24	272	381
8. Clarification of rules for payment of estimated tax for certain deemed asset sales	toa DOE	51	37	10	3	3	3	3	4	4	5	104	123
9. Extension of IRS user fees (through 9/30/13) [9]	rma DOE	33	34	35	36	38	39	41	42	44	45	176	386
10. Double certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements	oyo/a DOE	2	1	1	[14]	[14]	[14]	[14]	[14]	[14]	[14]	4	6
11. Add vaccines against Hepatitis A to the list of taxable vaccines [15]	[16]	6	9	9	9	9	9	9	9	9	9	42	87
12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence	sopra DOE	[6]	11	13	15	17	19	21	23	25	27	56	171
13. Authorize IRS to enter into installment agreements that provide for partial payment	laeio/a DOE	40	14	5	[6]	[6]	[6]	[6]	[6]	[6]	[6]	60	63
14. Lease term to include certain service contracts	leia DOE	14	26	41	57	74	92	110	129	150	171	212	864
Total of Other Revenue Provisions		179	264	302	295	292	305	325	350	381	413	1,334	3,112
Total of Additional Provisions		**1,893**	**2,136**	**2,123**	**2,056**	**2,158**	**2,361**	**2,601**	**2,906**	**3,264**	**3,657**	**10,368**	**25,168**
NET TOTAL		**1,587**	**2,108**	**1,688**	**1,953**	**1,448**	**1,040**	**-592**	**-1,691**	**-2,786**	**-4,756**	**8,786**	**12**

Joint Committee on Taxation

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

[Legend and Footnotes for JCX-84-03 appear on the following page]

Legend and Footnotes for JCX-84-03:

Legend for "Effective" column:

aa = acquisitions after
aoa = acquisitions occurring after
apoamt30da = amounts paid or accrued more than 30 days after
apoia = amounts paid or incurred after
ata = actions taken after
ctada = contributions, transfers, and distributions after
da = distributions after
diia = debt instrument issued after
DOE = date of enactment

dpa = documents prepared after
dpoia = damages paid or incurred after
iaeio/a = installment agreements entered into on or after
lf = losses for
oco/a = offenses committed on or after
oyo/a = open years on or after
padoa = purchases and dispositions occurring after
pma = payments made after
rfa = returns filed after

rma = requests made after
sopra = sales of principal residences after
ta = transactions after
teia = transactions entered into after
toa = transactions occurring after
to/a = transactions on or after
tyba = taxable years beginning after
tyea = taxable years ending after

[1] Includes estimate for binding contract relief.
[2] Effective for excess foreign taxes that may be carried forward to any taxable year beginning after December 31, 2004.
[3] Loss of less than $1 million.
[4] Effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. persons owning stock of such corporations with or within such corporations' taxable years end.
[5] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the material advisor and investor list disclosure provisions applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the failure to register tax shelter penalty applies to returns the due date for which is after the date of enactment; the investor list penalty applies to requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.
[6] Gain of less than $1 million.
[7] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[8] Effective for taxable years with respect to which the period for assessing deficiencies did not expire before October 1, 2003.
[9] Estimate provided by the Congressional Budget Office.
[10] Effective for all taxable years, whether beginning before, with, or after the date of enactment.
[11] Effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and to taxable years of U.S. shareholders in which or with which such taxable years of controlled corporations end.
[12] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002.
[13] Generally effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after February 5, 2003.
[14] Gain of less than $500,000.
[15] Estimate contains outlay effects that will be provided by the Congressional Budget Office.
]16] Effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

MODIFICATION OF THE CHAIRMAN'S MARK ON THE "JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on October 1, 2003

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

October 1, 2003
JCX-85-03

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on October 1, 2003, of S. 1637, the "Jumpstart Our Business Strength (JOBS) Act," together with additional provisions not included in S. 1637 as introduced. A description of the Chairman's mark of the JOBS Act and the additional provisions was published on September 26, 2003.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Modification. This document is divided into three parts. The first part describes modification to proposals included in the Chairman's mark. The second part describes new proposals that were not included in the Chairman's mark. The third part includes new revenue offset proposals, not included in the Chairman's mark.

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[1] Joint Committee on Taxation, *Description of the Chairman's Mark of the "Jumpstart Our Business Strength (JOBS) Act"* (JCX-83-03), September 26, 2003.

[2] This document may be cited as follows: Joint Committee on Taxation, *Modification to the Chairman's Mark on the "Jumpstart Our Business Strength (JOBS) Act"* (JCX-85-03), October 1, 2003.

I. MODIFICATIONS TO PROVISIONS IN THE CHAIRMAN'S MARK

A. Deduction Relating to Income Attributable to United States Production Activities

In general

The modification limits the deduction for a taxable year to 50 percent of the wages paid by the taxpayer during such taxable year with respect to domestic production activities.

The modification also extends the allowable deduction to partnerships and sole proprietorships. The term "sole proprietorship" is defined to include any individual taxpayer for any taxable year for which the taxpayer reports gross profit on Schedule C (Profit or Loss From Business) or Schedule F (Profit or Loss From Farming) of Form 1040. With respect to partnerships, the modification includes certain anti-abuse rules and reporting requirements. The anti-abuse rules include restrictions on the special allocation of the deduction to partners by requiring that a partner's distributive share of the deduction be consistent with such partner's distributive share of qualified production activities income. The reporting requirements provide that the IRS will require additional information concerning eligibility for the deduction to be reported on relevant tax forms filed by the taxpayer. For example, the modification requires the tax matters partner for the partnership to certify on the partnership tax return that the partnership is eligible for the full amount of the deduction claimed on the return. The ability of partners to claim their distributive share of the deduction is subject to the passive activity loss limitations of section 469 of the Code.

The modification also modifies the special rule for partnerships with corporate partners to conform to the treatment of partnerships under the modification.

Qualified production activities income

The modification modifies the reduction in qualified production activities income by virtue of the domestic/worldwide fraction. For taxable years beginning before 2010, the reduction in qualified production activities income by virtue of the domestic/worldwide fraction is 100 percent. For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is 75, 50, and 25 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

Qualifying production property

The modification eliminates the exclusion of unprocessed timber which is softwood from the definition of "qualifying production property". Thus, the term "qualifying production property" includes such property under the modification.

The modification also eliminates the exclusion of primary products of oil or gas from the definition of "qualified production property". The modification is limited to primary products that are produced (or processed) at an oil or gas refinery. In the case of crude oil, the modification does not apply to any taxpayer that directly or indirectly sells oil or natural gas at

retail, and does not apply to any taxpayer or a related person for a taxable year if on any day during such taxable year, the crude oil refinery runs of the taxpayer and such related person exceed 50,000 barrels.

The modification also clarifies that, for purposes of the definition of "qualified production property," property described in section 168(f)(3) or (4) of the Code includes underlying copyrights and trademarks.[3]

[3] Property described in section 168(f)(3) or (4) is treated as "qualified production property" if more than 50 percent of the development or production costs of such property are incurred by the taxpayer within the United States. For this purpose, property that is acquired by the taxpayer after development or production has commenced, but before such property generates substantial gross receipts, shall be treated as developed or produced by the taxpayer, provided the property would satisfy the requirements of the modification if such property had been developed or produced by the taxpayer.

B. Twenty-Year Foreign Tax Credit Carryforward

The modification makes the extended carryforward period effective for excess foreign taxes that may be carried to any taxable years ending after the date of enactment of the proposal. The modification also replaces the present-law two-year carryback period with a one-year carryback period for credits arising in taxable years beginning after the date of enactment of the proposal.

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

The modification clarifies that the look-through rule applies to dividends that a controlled foreign corporation receives from a 10/50 company and then distributes to a U.S. shareholder.

D. Interest Expense Allocation Rules

The modification makes the proposal effective for taxable years beginning after December 31, 2008. The general election under the proposal must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. The financial institution group election must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation.

E. Tax Treatment of Inversion Transactions

The modification removes the "pre-filing procedure" set forth in the proposal in the Chairman's mark. In its place, the modification enhances the accuracy-related penalties as applied to taxpayers that would have been subject to this procedure. Specifically, the 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to such taxpayers. In addition, the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers.

F. Disallowance of Certain Partnership Loss Transfers

The provision relating to the disallowance of certain partnership loss transfers is deleted from the Chairman's mark.

II. ADDITIONAL PROVISIONS

The modification adds the following additional provisions.

A. International Tax

1. Subpart F exception for active aircraft and vessel leasing income

Present Law

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

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries.

In addition, foreign base company shipping income includes dividends and interest that a controlled foreign corporation receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a controlled foreign corporation's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation. Under a coordination rule, income that is treated as foreign base company shipping income of a corporation is not treated as any other type of foreign base company income of such corporation for purposes of subpart F.

Subpart F income also includes foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does

not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Description of Proposal

The proposal provides that "qualified leasing income" derived from or in connection with the leasing or rental of any aircraft or vessel is not treated as foreign personal holding company income or foreign base company shipping income of a controlled foreign corporation. The proposal defines "qualified leasing income" as rents or gains derived in the active conduct of a leasing trade or business with respect to which the controlled foreign corporation conducts substantial activity, provided that the leased property is used by the lessee or other end-user in foreign commerce and predominantly outside the United States, and such lessee or other end-user is not related to the controlled foreign corporation (within the meaning of sec. 954(d)(3)).

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders ending with or within such taxable years of such foreign corporations.

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

Present Law

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

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign

corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

Description of Proposal

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

Effective Date

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

3. Look-through treatment under subpart F for sales of partnership interests

Present Law

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

Description of Proposal

The proposal treats the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly, indirectly, or constructively at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a controlled foreign

corporation that meets this ownership threshold constitutes subpart F income under the proposal only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

Effective Date

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

4. Election not to use average exchange rate for foreign tax paid other than in functional currency

Present Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.[4] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[5]

Description of Proposal

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the proposal provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional

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[4] Sec. 986(a)(1).

[5] Sec. 986(a)(2).

currency.[6] Any election under the proposal applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The proposal authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

Effective Date

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

5. Foreign tax credit treatment of "base difference" items

Present Law

In order to mitigate the possibility of double taxation of cross-border income, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[7] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) ("general limitation" income).

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[8] In cases in which foreign law imposes

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

[7] Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits).

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

tax on an item of income that does not constitute income under U.S. tax principles (a "base difference" item), the tax is treated as imposed on income in the general limitation category.[9]

Description of Proposal

Under the proposal, creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed either on general limitation income or on financial services income, at the taxpayer's election. Once made, this election applies to all such taxes and is revocable only with the consent of the Treasury Secretary.

Effective Date

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

6. Modification of exceptions under subpart F for active financing income

Present Law

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

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

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

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[10]

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

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

Description of Proposal

The proposal modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the proposal provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is

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

performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country.

Effective Date

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

7. United States property not to include certain assets of controlled foreign corporation

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year (sec. 951(a)(1)(B)).

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

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

secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

Description of Proposal

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

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

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

Effective Date

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

8. Provide equal treatment for interest paid by foreign partnerships and foreign corporations

Present Law

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[11] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[12] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[13]

Description of Proposal

The proposal treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The proposal applies only to foreign partnerships that are principally owned by foreign persons. For this purpose, a foreign partnership is principally owned by foreign persons if non-U.S. residents or foreign corporations in the aggregate own more than 80 percent of the capital and profits interests in the partnership.

Effective Date

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

9. Foreign tax credit treatment of deemed payments under section 367(d)

Present Law

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible

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

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

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

property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[14]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[15] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[16]

Description of Proposal

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

Effective Date

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

10. Modify FIRPTA rules for real estate investment trusts

Present Law

A real estate investment trust ("REIT") is a U.S. entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible

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

[15] Sec. 904(d).

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

by the REIT, and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income to its investors before the end of its taxable year.

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property, including certain transactions involving REITs. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA").

In general, FIRPTA provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a U.S. trade or business during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons. For these purposes, the receipt of a distribution from a REIT is treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT. These capital gains distributions from REITs generally are subject to withholding tax at a rate of 35 percent (or a lower treaty rate). In addition, the recipients of these capital gains distributions are required to file Federal income tax returns in the United States, since the recipients are treated as earning income effectively connected with a U.S. trade or business.

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions.

Description of Proposal

The proposal removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT, provided that (1) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the United States and (2) the foreign investor does not own more than 5 percent of the class of stock at any time during the taxable year within which the distribution is received.

Thus, a foreign investor is not required to file a U.S. Federal income tax return by reason of receiving such a distribution, and the distribution is to be treated as a dividend to that investor. Also, the branch profits tax no longer applies to such a distribution.

Effective Date

The proposal applies to taxable years beginning after the date of enactment.

11. Temporary rate reduction for certain dividends received from controlled foreign corporations

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[17] and the passive foreign investment company rules.[18] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[19]

Description of Proposal

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

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[20] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

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

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[17] Secs. 951-964.

[18] Secs. 1291-1298.

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

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

development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation."

The proposal disallows 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and removes 85 percent of the underlying income from the taxpayer's foreign tax credit limitation fraction under section 904.

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

Effective Date

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

12. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals

Present Law

Under section 871, certain items of gross income received by a nonresident alien from sources within the United States are subject to a flat 30-percent withholding tax. Gambling winnings received by a nonresident alien from wagers placed in the United States are U.S.-source and thus generally are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S.-source gambling winnings of residents of the other treaty country from U.S. withholding tax. In addition, no withholding tax is imposed under section 871 on the non-business gambling income of a nonresident alien from wagers on the following games (except to the extent that the Secretary determines that collection of the tax would be administratively feasible): blackjack, baccarat, craps, roulette, and big-6 wheel. Various other (non-gambling-related) items of income of a nonresident alien are excluded from gross income under section 872(b) and are thereby exempt from the 30-percent withholding tax, without any authority for the Secretary to impose the tax by regulation. In cases in which a withholding tax on gambling winnings applies, section 1441(a) of the Code requires the party making the winning payout to withhold the appropriate amount and makes that party responsible for amounts not withheld.

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[21] event taking place within the United States, the

[21] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

Description of Proposal

The proposal provides an exclusion from gross income under section 872(b) for winnings paid to a nonresident alien resulting from a legal wager initiated outside the United States in a pari-mutuel pool on a live horse or dog race in the United States, regardless of whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Effective Date

The proposal is effective for wagers made after the date of enactment of the proposal.

13. Require commerce department report on adverse decisions of the world trade organization

Present Law

The Secretary of Commerce does not have an obligation to report to transmit a report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means, in consultation with the United States Trade Representative, regarding whether dispute settlement panels and the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, and safeguard measures not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

Description of Proposal

The proposal requires that by no later than March 31, 2004, the Secretary of Commerce, in consultation with the United States Trade Representative, shall transmit a report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means regarding whether dispute settlement panels and the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, and safeguard measures

not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

Effective Date

The proposal is effective on the date of enactment.

14. Consultative role for Senate Committee on Finance in connection with the review of proposed tax treaties

Present Law

The United States maintains a network of bilateral tax treaties that limit the amount of tax that may be imposed by one treaty country on residents of the other treaty country. Most of these treaties are income tax treaties designed to reduce or eliminate the double taxation of income earned by residents of either country from sources within the other country, and to prevent the avoidance or evasion of the taxes of the two countries.

Under the Constitution, treaties become effective only upon the advice and consent of the Senate. After a proposed tax treaty is signed and formally transmitted by the President to the Senate, the Senate Committee on Foreign Relations reviews the proposed treaty, conducts ratification hearings, and reports to the Senate with a recommendation as to ratification of the proposed treaty. The Senate Committee on Finance has no formal role in the process.

Description of Proposal

Under the proposal, the Senate Committee on Foreign Relations would be required to consult with the Senate Committee on Finance with respect to proposed tax treaties prior to reporting any such treaty to the Senate. The Senate Committee on Finance would be required to respond in writing within 120 days of receipt of a request for consultation from the Senate Committee on Foreign Relations. If the Senate Committee on Finance does not respond within this time period, the Committee will be considered to have waived the right to consult with respect to the provisions of the tax treaty.

The Senate Committee on Foreign Relations would be required to consider the views of the Senate Committee on Finance when reporting a tax treaty to the Senate and would be required to include the views of the Senate Committee on Finance in its report to the Senate.

Effective Date

The proposal would be effective on the date of enactment.

15. Study of impact of international tax law on taxpayers other than large corporations

Present Law

The United States employs a "worldwide" tax system, under which U.S. persons (including domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including foreign corporations) are subject to U.S. tax only on certain income U.S. source income and income that has a sufficient nexus to the United States. The United States generally provides a credit to U.S. persons for foreign income taxes paid or accrued.[22] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[23]

Within this basic framework, there are a variety of rules that affect the U.S. taxation of cross-border transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S.-source income. Such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign-source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deductions between related persons in order to ensure the clear reflection of the income of each person and to prevent the avoidance of tax. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on certain income from foreign operations of certain U.S.-owned foreign corporations.

A cross-border transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and mitigate the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

Description of Proposal

The proposal requires the Secretary of the Treasury or the Secretary's delegate to conduct a study of the impact of Federal international tax rules on taxpayers other than large corporations, including the burdens placed on such taxpayers in complying with such rules. In addition, not later than 180 days after the date of the enactment of this proposal, the Secretary shall report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives the results of the study conducted as a result of this proposal,

[22] Sec. 901.

[23] Secs. 901, 904.

including any recommendations for legislative or administrative changes to reduce the compliance burden on taxpayers other than large corporations and for such other purposes as the Secretary determines appropriate.

Effective Date

This proposal is effective after date of enactment.

B. Domestic Manufacturing and Business Provisions

1. Expansion of qualified small-issue bond program

Present Law

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. This $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the limit. Outstanding aggregate borrowing under this program is limited to $40 million per borrower (including related parties) regardless of where the property is located. No more than $250,000 per borrower ($62,500 for used property) may be used to finance depreciable farm property.

Property and businesses eligible for this financing are specified. For example, only depreciable property (and related real property) used in the production of tangible personal property is eligible for financing as a manufacturing facility. Storage and distribution of products generally is not treated as production under this provision. Agricultural land and equipment may only be financed for first-time farmers, defined as individuals who have not at any prior time owned farmland in excess of (1) 15 percent of the median size of a farm in the same county or (2) $125,000 in value.

Before 1987, qualified small-issue bonds also could be used to finance commercial facilities. In addition to general prohibitions on the tax-exempt private activity bond financing of certain facilities, Federal law precluded the use of qualified small-issue bonds to finance a broader list of facilities during that period. For example, no more than 25 percent of a bond issue could be used to finance restaurants, bars, automobile sales and service facilities, or entertainment facilities. No portion of these bond proceeds could be used to finance golf courses, country clubs, massage parlors, tennis clubs or other racquet sport facilities, skating facilities, hot tub facilities, or racetracks.

Description of Proposal

The proposal increases the maximum allowable amount of total capital expenditures by a business in the same municipality or county during the six-year period from $10 million to $20 million. However, the proposal does not change the present-law requirement that no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. As under present-law, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the total capital expenditures limit.

Effective Date

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

2. Expensing of investment in broadband equipment

Present Law

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

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Rev. Proc. 87-56, 1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

Description of Proposal

The proposal provides that expenses incurred by the taxpayer for qualified broadband expenditures with respect to qualified equipment placed in service prior to January 1, 2005 may be deducted in full in the year in which the equipment is placed in service.

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

Qualified subscribers for the purposes of the current generation broadband deduction include nonresidential subscribers in rural or underserved areas, and residential subscribers in rural or underserved areas that are not in a saturated market. A saturated market is defined as a census tract in which current generation broadband services have been provided by a single provider to 85 percent or more of the total number of potential residential subscribers residing within such census tracts. For the purposes of the next generation broadband deduction,

qualified subscribers include nonresidential subscribers in rural or underserved areas or any residential subscriber. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment would be capable of serving.

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

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

Effective Date

The proposal is effective for property placed in service after December 31, 2003.

3. Exemption for natural aging process from interest capitalization

Present Law

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

Special rules apply for the allocation of interest expense to property produced by the taxpayer.[24] In general, interest paid or incurred during the production period of certain types of

[24] Sec. 263A(f).

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

Description of Proposal

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

Effective Date

The proposal applies to production periods beginning after the date of enactment.

4. Section 355 "active business test" applied to chains of affiliated corporations

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[25] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[26]

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[25] Sec. 355(b). If the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[26] Sec. 355(b)(2)(A).

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes had been that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[27] However, the IRS recently removed this requirement in the context of a new revenue procedure.[28] If the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[29]

Description of Proposal

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

Effective Date

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

The proposal also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[30]

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

[28] Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

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

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

5. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes. Certain types of income, such as rents, royalties, dividends, and interest, generally are excluded from unrelated business taxable income except when such income is derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.[31] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property. An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is not treated as the creation of a new indebtedness.

Description of Proposal

The proposal modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act, or (2) held or guaranteed by the Small Business Administration.

Effective Date

The proposal is effective for debt incurred by a small business investment company after December 31, 2003, with respect to property it acquires after such date.

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

6. Modified taxation of imported archery products

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more.[32] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[33] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[34]

Description of Proposal

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more. The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the proposal. The proposal provides that the 12-percent excise tax on arrows will not apply if the arrow contains an arrow shaft upon which the tax imposed on arrow components has been paid. Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

7. Modify cooperative marketing rules to include value added processing involving animals

Present Law

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

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32 Sec. 4161(b)(1)(A).

33 Sec. 4161(b)(2).

34 Sec. 4161(b)(1)(B).

amount of additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

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

Description of Proposal

The proposal provides that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

Effective Date

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

8. Extend declaratory judgment procedures to farmers' cooperative organizations

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[35] In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

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[35] For disputes involving the initial or continuing qualification of an organization described in sections 501(c)(3), 509(a), or 4942(j)(3), declaratory judgment actions may be brought in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. For all other Federal tax declaratory judgment actions, proceedings may be brought only in the U.S. Tax Court.

Description of Proposal

The proposal extends the declaratory judgment procedures to cooperatives. Such a case may be commenced in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and such court would have jurisdiction to determine a cooperative's initial or continuing qualification as a farmers' cooperative described in section 521.

Effective Date

The proposal is effective for pleadings filed after the date of enactment.

9. Repeal personal holding company tax

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Table 1.–Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0 - $50,000	15 percent of taxable income
$50,001 - $75,000	25 percent of taxable income
$75,001 - $10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333.

When a corporation distributes its after-tax earnings to individual shareholders as dividends, a tax is imposed on the shareholders at rates up to 15 percent.[36] If a corporation receives a dividend from another corporation, the recipient corporation is entitled to a dividends-received deduction that excludes a significant part of the dividend from the recipient's income. The percentage of a dividend received that is deducted varies from 70 percent to 100 percent, depending on the level of ownership of the recipient corporation in the distributing corporation.[37]

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[36] The 15-percent rate applies to dividends received in taxable years beginning before January 1, 2009. Dividends received on or after that date are scheduled to be taxed at the rates applicable to ordinary income, which range up to 35 percent (39.6 percent for taxable years beginning after December 31, 2010).

[37] If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. If the recipient corporation owns less than 80

Thus, with a 70 percent dividends received deduction, the tax rate imposed on a dividend received by a corporation in the 35-percent tax bracket is 10.5 percent.[38] For corporations at lower rate brackets, the tax rates on these dividends are lower.

In addition to the regular corporate income tax, a corporate level penalty tax, "the "personal holding company tax" is currently imposed at 15 percent [39] on certain corporate earnings of personal holding companies that are not distributed to shareholders. The personal holding company tax was originally enacted to prevent so-called "incorporated pocketbooks" that could be formed by individuals to hold assets that could have been held directly by the individuals, such as passive investment assets, and retain the income at corporate rates that were then significantly lower than individual tax rates.

Corporations are personal holding companies only if they are closely held and have substantial passive income. A corporation is closely held if, at any time during the last half of the taxable year, more than 50 percent of the value of the stock of the corporation is owned, directly or indirectly, by five or fewer individuals (determined with the application of specified attribution rules). A corporation has substantial passive income if at least 60 percent of the corporation's adjusted ordinary gross income (as defined for this purpose) is "personal holding company income," generally, income from interest, dividends, rents, royalties, compensation for use of corporate property by certain shareholders, and income under contracts giving someone other than the corporation the right to designate the individual service provider. Numerous adjustments apply in specified situations where there are specified indicia that the income is active rather than passive.

A corporation that otherwise would be subject to personal holding company tax can distribute, or can agree to be deemed to have distributed, its modified taxable income and avoid the tax. A corporation may make such an actual dividend distribution during its taxable year or until the 15th day of the third month following the close of its taxable year. In addition, if an election is filed with its return for the year, its shareholders may agree to include a deemed amount in their income as if a dividend had been paid ("consent dividend"). A corporation may also make a "deficiency dividend" distribution within 90 days following a determination by the IRS or a court that personal holding company tax liability is due. That distribution can eliminate the personal holding company tax itself, though interest (and penalties, if any) with respect to such tax would still be owed to the IRS.[40]

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percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns 80 percent or more of the distributing corporation, the dividends received deduction is generally 100 percent.

[38] This is the 35 percent tax rate, applied to the 30 percent of the dividend that is taxable after a 70 percent dividends-received deduction.

[39] This rate is scheduled to return to the highest individual tax rate when the lower dividend tax rate expires.

[40] Section 547.

Corporations that are not personal holding companies may be subject the accumulated earnings tax. The tax is imposed at the same rate as the personal holding company tax. Unlike the personal holding company tax definition, which is very specific regarding the percentages of ownership and of various types of income that can trigger the tax if earnings are not distributed, the situations in which the accumulated earnings tax may apply are determined on a more subjective basis. The tax is imposed on a corporation that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."[41] If earnings (from any type of income) "are permitted to accumulate beyond the reasonable needs of the business", the prohibited purpose is presumed to exist "unless the corporation by the preponderance of the evidence shall prove to the contrary".[42]

A corporation that is a "mere holding or investment company" is presumed to be accumulating earnings for the purpose of avoiding distributions to shareholders.[43] Unlike the personal holding company rules, there are no specific rules for determining what level of active income would avoid this definition.

A safe harbor de-minimis exemption, the "accumulated earnings credit", generally permits a corporation (including a mere holding or investment company) to accumulate a total of $250,000 of earnings without becoming subject to any risk of the tax being imposed.[44]

Description of Proposal

The proposal would repeal the personal holding company tax for the period of time until the 15 percent rate on dividends received by individuals is scheduled to expire.

Effective Date

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

The proposal would be treated, for purposes of section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 as enacted by Title III of that Act (relating to lower rates on capital gains and dividends), so that the proposal would terminate when those provisions terminate (currently scheduled to be for taxable years beginning after December 31, 2008).

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[41] Section 532(a).

[42] Section 533(a).

[43] Section 533(b).

[44] Section 535(c). The accumulated earnings credit is the amount, if any, by which the credit amount exceeds the total earnings and profits already accumulated as of the close of the prior taxable year. Certain service companies have a lower credit amount of $150,000. Section 535(c)(2)(B).

C. Manufacturing Relating to Films

1. Special rules for certain film and television production

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Description of Proposal

The proposal permits qualifying film and television productions to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.

The proposal limits the amount of production expenditures that may be expensed to $15 million for each qualifying production. An additional $5 million of production expenditures may be expensed (up to $20 million in total) if the production expenditures occur in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. Expenditures in excess of the $15 million (or $20 million in distressed areas) are required to be recovered over a three-year period using the straight-line method.

The proposal defines a qualified film or television production as any production of a motion picture (whether released theatrically or directly to video cassette or any other format); mini series; scripted, dramatic television episode; or movie of the week if at least 75 percent of the wages expended on the production are for services performed in the United States. With respect to property which is one or more episodes in a television series, only the first 44 episodes qualify under the proposal. Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

The proposal also requires the Commerce Department to report on whether the proposal materially aided in retaining film production in the U.S. The report is required to be submitted to the Senate Committee on Finance and the House Committee on Ways and Means no later than December 31, 2006.

Effective Date

The proposal is effective for qualifying productions started after the date of enactment.

2. Modification of application of income forecast method of depreciation

Present Law

Depreciation

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Income forecast method of depreciation

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

Description of Proposal

The proposal clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in section 167(g)(1)(A)). For purposes of the proposal, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. The proposal also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property.

The proposal also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

In addition, the proposal clarifies that, in the case of property eligible for the income forecast method that the holding in the Associated Patentees decision will continue to constitute a valid method of depreciation and may be used in connection with the income forecast method of accounting. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may elect to deduct those payments as they are paid as under the Associated Patentees decision. This election shall be made on a property-by-property basis and shall be applied consistently with respect to a given property thereafter. The proposal also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective Date

The proposal applies to property placed in service after date of enactment. No inference is intended as to the appropriate treatment under present law. It is intended that the Treasury Department and the IRS expedite the resolution of open cases. In resolving these cases in an expedited and balanced manner, the Treasury Department and IRS are encouraged to take into account the principles of the bill.

D. Manufacturing Relating to Timber

1. Expensing of reforestation expenses

Present Law

Amortization of reforestation costs (sec. 194)

A taxpayer may elect to amortize up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Amortization is taken over 84 months (seven years) and is subject to a mandatory half-year convention. In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (i.e., an "above-the-line deduction") rather than as an itemized deduction.

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity. Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.

The amount amortized is reduced by one half of the amount of reforestation credit claimed under section 48(b) (see below). Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.

Reforestation tax credit (sec. 48(b))

A tax credit is allowed equal to 10 percent of the reforestation expenditures incurred during the year that are properly elected to be amortized. An amount allowed as a credit is subject to recapture if the qualifying timber property to which the expenditure relates is disposed of within five years.

Description of Proposal

The proposal permits taxpayers to elect to deduct (*i.e.*, expense) up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Any expenses above $10,000 ($5,000) would be amortized over a seven-year period.

The proposal replaces both the amortization and credit provisions of present law.

Effective Date

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

2. Election to treat cutting of timber as a sale or exchange

Present Law

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

Description of Proposal

Under the proposal, the election to treat the cutting of timber as a sale or exchange may be revoked by the taxpayer on a one-time basis.

Effective Date

The proposal is effective on date of enactment.

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

Present Law

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

Description of Proposal

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

Effective Date

The proposal applies to sales of timber after date of enactment.

4. Modified safe harbor rules for timber REITs

Present Law

In general

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

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

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. A 100-percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business[45], other than foreclosure property.[46] A safe harbor is provided for certain sales of rent producing real property that otherwise might be considered prohibited transactions. The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year. The safe harbor only applies to property that has been held by the REIT for at least four years. In addition, property is eligible for the safe harbor only if the aggregate expenditures made directly or indirectly by the REIT during the four-year period prior to date of sale do not exceed 30 percent of the net selling price of the property.

Certain timber income

REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT to its taxable REIT subsidiary, which cuts and logs the trees and processes the timber to produce lumber, or lumber products such as plywood or composite. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real

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

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

property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[47]

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than five percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[48]

Special rules for Taxable REIT subsidiaries

Under an exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a REIT[49] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[50]

Description of Proposal

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

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

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

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

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

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

(2) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;[51]

(3) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property and that are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland must not exceed five percent of the net selling price of the property;[52]

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[51] Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (i.e., silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods, grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); (2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4) nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; (7) initial stand fertilization, up through stand establishment; (8) construction cost of road to be used for removal of logs or fire protection; (9) environmental costs (i.e., habitat conservation plans); (10) any post stand capital establishment costs (e.g., "mid-term fertilization costs)."

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

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

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

(6) The sales price on the sale of the property to a taxable REIT subsidiary cannot be based in whole or in part on the income or profits that the subsidiary derives from the sales of such properties.

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

Effective Date

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

property incurred by the REIT (e.g., engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber).

III. ADDITIONAL REVENUE OFFSETS

A. International Tax

1. Clarification of banking business for purposes of determining investment of earnings in U.S. property

Present Law

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain

unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[53] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

Description of Proposal

The proposal provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with "banks" (including foreign branches) as defined under section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)), without regard to sections 2(c)(1)(C) and 2(c)(1)(G) of such Act.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited*.

Effective Date

This proposal is effective on the date of enactment.

2. Prohibition on nonrecognition of gain through complete liquidation of holding company

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

[53] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

Description of Proposal

The proposal treats as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

Effective Date

The proposal is effective for distributions occurring on or after the date of enactment.

3. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign

corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (sections 951-964), the passive foreign investment company rules (sections 1291-1298), and the foreign personal holding company rules (sections 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[54] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[55] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[56]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[57] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[58] As in the case of OID, the Treasury regulations additionally provide

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[54] Section 163(e)(1).

[55] Section 163(e)(3).

[56] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue has in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[57] Section 267(a)(2).

[58] Treas. Reg. sec. 1.267(a)-3(b)(1), (c).

that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[59]

Description of Proposal

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of all of the direct or indirect U.S. owners of the related foreign person under the relevant inclusion rules. Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid. The provision provides an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the provision grants the Secretary regulatory authority to determine the manner of proper allocations to shareholders, and to provide exceptions to these rules. It is intended that these rules should apply to OID, interest, and amounts other than interest that are non-effectively connected foreign source income of a related foreign person.

Effective Date

The provision is effective for payments accrued on or after date of enactment.

4. Apply earnings-stripping rules to partnerships and S corporations

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[60] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

The present-law earnings stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as debt of the corporate partner for purposes of applying the earnings

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[59] Treas. Reg. sec. 1.267(a)-3(c)(4).

[60] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

stripping limitation to its own interest payments.[61] In addition, interest paid or accrued by a partnership is treated as interest expense of a corporate partner, with the result that a deduction for the interest expense may be disallowed if that expense would be disallowed under the earnings stripping rules if paid by the corporate partner itself.[62] The proposed regulations also provide that the earnings stripping rules do not apply to subchapter S corporations.[63] Thus, under present law and the proposed regulations, a partnership or S corporation generally is allowed a deduction for interest paid or accrued on indebtedness that it issues that otherwise would be disallowed under the earnings stripping rules in the case of a subchapter C corporation.

Description of Proposal

The proposal provides that the deduction for interest paid or accrued by partnerships and S corporations is subject to disallowance under the earnings stripping rules if the partnership or S corporation meets the tests that would apply under present law if the partnership or S corporation were a C corporation. Thus, for example, the deduction for interest paid by a partnership to a related person that is exempt from tax would be disallowed if the debt-equity ratio of the partnership exceeds 1.5 to 1 and the interest expense of the partnership exceeds 50 percent of the partnership's adjusted taxable income. As a result, no deduction for this interest would be available to any of the partners. Although an S corporation cannot have foreign shareholders under present law, "disqualified interest" subject to the earnings stripping rules would include interest paid to tax-exempt organizations that are shareholders of the S corporation and interest paid to other related parties as defined under the current rules.

The proposal incorporates a rule attributing partnership debt to a corporate partner for purposes of applying the earnings stripping rules to the corporation.[64] The rule attributing partnership interest expense to corporate partners for potential disallowance under the earnings stripping rules[65] apply under the proposal only after the earnings stripping rules have been applied at the partnership level. If interest expense of the partnership is disallowed under the proposal, there is no deduction allocated to the corporate partners. If the interest deduction is not disallowed at the partnership level, the amount allocated to a corporate partner would be subject again to disallowance under the proposed Treasury regulations based upon the attributes of the corporate partner.

Effective Date

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

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[61] Prop. Treas. reg. sec. 1.163(j)-3(b)(3).

[62] Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[63] Prop. Treas. reg. sec. 1.163(j)-1(a)(i).

[64] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[65] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

5. Excise tax on stock compensation of insiders of inverted corporations

Present Law

The income taxation of a nonstatutory[66] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[67] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Description of Proposal

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's inversion date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934

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66 Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

67 If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

with respect to the corporation, or any member of the corporation's expanded affiliated group,[68] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[69] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the proposal.

Specified stock compensation subject to the excise tax includes any payment[70] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the proposal applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value

[68] An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

[69] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

[70] Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual is paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the inversion transaction, and to any specified stock compensation awarded in the six-month period beginning with the inversion transaction. As a result, for example, if a corporation were to cancel outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Treasury Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable twelve-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the inversion or to any stock acquired pursuant to such exercise to the extent income is recognized under section 83. The excise tax also does not apply to any specified stock compensation that is sold, exchanged, distributed or cashed-out during such period in a transaction in which gain or loss is recognized in full.

For specified stock compensation held on the inversion date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the inversion date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the inversion date is valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of

the stock at valuation nevertheless have a fair value and are subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Treasury Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the proposal. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the inverted corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Treasury Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance would include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Treasury Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the section.

Effective Date

The proposal is effective as of July 11, 2002, except that periods before July 11, 2002, are not taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the inversion date.

6. 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.[71] 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.[72] 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 clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[73] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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[71] Sec. 845(a).

[72] 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).

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

No regulations have been issued under section 845(a). It is expected that the Treasury Secretary will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

Effective Date

The proposal is effective for any risk reinsured after April 11, 2002.

7. Reporting of taxable mergers and acquisitions

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

Description of Proposal

Under the proposal, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[74]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements is extended to failures to comply with the requirements set forth under the proposal.

Effective Date

The proposal is effective for acquisitions after the date of enactment.

[74] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

B. Other Revenue Offsets

1. Modify qualification rules for tax-exempt property and casualty insurance companies

Present Law

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshhold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

Description of Proposal

The proposal modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Under the proposal, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account. The proposal expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the proposal. Under the proposal, the term "insurance company" means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a) and new sec. 831(c)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.[75] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

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[75] *See, e.g., Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).

The proposal also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (without regard to whether such premiums exceed $350,000) (sec. 831(b)). As under present law, for purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the proposal, including, for example, by attempts to characterize as premiums any income that is other than premium income.

Effective Date

The proposals are effective for taxable years beginning after December 31, 2003.

2. Recognize cancellation of indebtedness income realized on satisfaction of debt with partnership interest

Present Law

Under present law, a corporation that transfers of its stock in satisfaction of its debt must recognize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock.[76] Prior to enactment of this present-law provision in 1993, case law provided that a corporation did not recognize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of debt (referred to as the "stock-for-debt exception").[77]

When cancellation of indebtedness income is realized by a partnership, it generally is allocated among the partners in accordance with their distributive shares. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations.[78] The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

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[76] Sec. 108(e)(8).

[77] *E.g.*, *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *nonacq.* 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.* 1943 C.B. 1.

[78] Sec. 108(a).

In the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly requires the partnership to realize cancellation of indebtedness income. Thus, it is unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt exception. It also is unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[79]

Description of Proposal

The proposal provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The proposal applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the proposal is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the proposal, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Effective Date

This proposal is effective for cancellations of indebtedness occurring on or after the date of enactment.

3. Modification of the straddle rules

Present Law

In general

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in

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[79] *See, e.g.*, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934); *American Seating Co. v. Commissioner*, 14 B.T.A. 328, *aff'd in part and rev'd in part*, 50 F.2d 681 (7th Cir. 1931); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940); Rev. Rul. 91-31, 1991-1 C.B. 19.

the straddle.[80] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

Positions in stock

The straddle rules also generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Although the straddles rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules do not apply if the option is a "qualified covered call option" written by the taxpayer. In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

The stock exception from the straddle rules has been curtailed severely by legislative amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[81]

Unbalanced straddles

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[82] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is

[80] Sec. 1092.

[81] Prop. Reg. sec. 1.1092(d)-2(c).

[82] Sec. 1092(c)(2)(B).

also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting to the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[83] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[84] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock--i.e., the number of shares specified in the costless collar--because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) and (3) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

Description of Proposal

The proposal modifies the straddle rules in three respects: (1) permit taxpayers to identify offsetting positions of a straddle; (2) provide a special rule with respect to certain physically settled positions of a straddle; and (3) repeal the stock and qualified covered call exceptions from the straddle rules.

Under the proposal, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. However, taxpayers are permitted to identify offsetting positions of a straddle only to the extent that the fair market value of the straddle position already held by the taxpayer at the inception of the straddle equals or exceeds its adjusted basis in the hands of the taxpayer. Straddle period losses are allocated to the identified straddle in proportion to the unrealized straddle period gains of the identified straddle and are capitalized into the basis of the offsetting position(s) that comprises the other leg(s) in the

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[83] PLR 199925044 (Feb. 3, 1999).

[84] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

identified straddle. In addition, the proposal provides authority to issue Treasury regulations that would: (1) specify the application of the straddle rules to a taxpayer who fails to properly identify the positions of the straddle on a timely basis; (2) reclassify improperly or inappropriately identified positions; (3) coordinate the provision with the wash sale rules under section 1091; and (4) provide an ordering rule for dispositions of less than an entire lot that has been partially offset in a properly identified straddle.

The proposal also requires taxpayers that settle an option or forward contract by delivering property to treat the settlement as a two-step transaction for purposes of applying the straddle rules. With respect to a physically settled option or forward contract, the taxpayer is required to treat the option or forward contract as if it was terminated for its fair market value immediately before settlement. Any resulting loss is capitalized into the offsetting position(s) that comprises the other leg(s) of the straddle. The taxpayer then is treated as selling the property used to physically settle the option or forward contract.

The proposal also eliminates the exceptions from the straddle rules for stock and qualified covered call options. Thus, offsetting positions involving actively traded stock generally constitute a straddle.

<u>Effective Date</u>

This proposal is effective for positions established on or after the date of enactment.

4. Clarify definition of nonqualified preferred stock

<u>Present Law</u>

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. For this purpose, preferred stock is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than nor that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised with 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

<u>Description of Proposal</u>

The proposal clarifies the definition of nonqualified preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited

and preferred as to dividends and does not participate in corporate growth to any significant extent.

As one example, instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred stockholders. As another example, stock that entitles the holder to a dividend that is the greater of 7 percent or the dividends common shareholders receive does not avoid being preferred stock if the common shareholders are not expected to receive dividends greater than 7 percent.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective Date

The proposal is effective for transactions after May 14, 2003.

C. Additional Revenue Offsets

1. Modify definition of controlled group of corporations

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Table 2.–Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0 - $50,000	15 percent of taxable income
$50,001 - $75,000	25 percent of taxable income
$75,001 - $10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333.

The component members of a controlled group of corporations are limited to one amount in each of the taxable income brackets shown above.[85] For this purpose, a controlled group of corporations means a parent-subsidiary controlled group and a brother-sister controlled group.

A brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of all stock, and (2) more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to the corporation.

Description of Proposal

Under the proposal, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account

[85] Components members are also limited to one alternative minimum tax exemption and one accumulated earnings credit.

the stock ownership of each person only to the extent the stock ownership is identical with respect to the corporation.

Effective Date

The proposal applies to taxable years beginning after the date of enactment.

2. Limit deduction for charitable contributions of patents and similar property

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[86] The amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets.[87]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[88] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[89]

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[86] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[87] *See* sec. 1221(a)(3), 1231(b)(1)(C).

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

[89] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

In general, charitable organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organization 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.

Description of Proposal

In general

The proposal provides that the amount of the deduction for charitable contributions of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property ("intellectual property") may not exceed the taxpayer's basis in the contributed property. The proposal permits a taxpayer to take such a deduction and to retain a right to receive certain payments from the donee organization, provided that the donor relinquishes ownership of the entire property.

The proposal does not change the rules for charitable contributions of intellectual property that under present law provide the donor a basis deduction (for example, copyrights described in sections 1221(a)(3) and 1231(b)(1)(C)). The proposal does not change present law rules regarding private inurement and private benefit.

Donor's right to receive certain payments

The donor's right to receive payments is limited to payments made by the donee organization and is subject to amount and time limitations. No single payment to the taxpayer made by the donee organization may exceed 50 percent of the amount of the corresponding payment received by the donee organization from a third party with respect to the contributed property. Payments are not permitted if made after the earlier of the expiration of the legal life of the contributed property or the date that is twenty years after the date of the contribution. The right to receive payments does not include a right to receive any portion of proceeds from a sale of the contributed property by the donee. The Secretary of the Treasury is authorized to apply similar limitations in cases where the donee does not receive payments from a third party with respect to the contributed property.[90]

The proposal provides that permitted payments will constitute ordinary income recognized by the donor when received, regardless of the donor's method of accounting. In cases where the donor receives permitted payments, the proposal overrides present-law rules regarding contributions of partial interests and bargain sales to the extent that they otherwise apply. In cases where the donor has a right to receive payments not permitted by the proposal, no charitable contribution deduction is allowed and the payments received by the donor are taxed under the generally applicable law.

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[90] For example, if the donee organization does not receive a payment, such as a royalty, from a third party with respect to the property, the Secretary of the Treasury is authorized to permit payments by the donee organization to the donor, but only to the extent that the benefit conferred to the donor does not exceed the benefit to the donee.

Treasury guidance regarding abusive situations

The proposal provides the Secretary of the Treasury with the authority to issue regulations or other guidance to prevent avoidance of the purposes of the proposal. In general, the provision is intended to prevent taxpayers from claiming a deduction in excess of basis with respect to charitable contributions of intellectual property. A taxpayer would contravene the purposes of the provision, for example, by engaging in transactions or other activity that manipulated the basis of the contributed property or changed the form of the contributed property in order to increase the amount of the deduction. This might occur, for instance, if a taxpayer, for the purpose of claiming a larger deduction, engaged in activity that increased the basis of the contributed property by using related parties, pass-thru entities, or other intermediaries or means. The purpose of the proposal also would be abused if a taxpayer changed the form of the property in order to claim a larger deduction by, for example, embedding the property into a product, contributing the product, and claiming a fair market value deduction based in part on the fair market value of the embedded property. In such abusive cases, any guidance issued by the Secretary of the Treasury shall provide that the taxpayer is required to separate the embedded property from the related product and treat the charitable contribution as contributions of distinct properties, with each property subject to the applicable deduction rules.

Effective Date

The provision is effective for contributions made after October 1, 2003.

3. Extension of customs user fees

Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 103-182 which extended authorization for the collection of these fees through fiscal year 2003.

Description of Proposal

The proposal extends the passenger and conveyance processing fees and the merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2013.

Effective Date

The proposal is effective upon the date of enactment.

4. Deposits made to suspend the running of interest on potential underpayments

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

Description of Proposal

In general

The proposal allows a taxpayer to deposit cash with the IRS that the may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is paid by the deposited amount for the period the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Withdrawal of amounts

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with

the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Thus, the interest received on withdrawn deposits will not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

Effective Date

The proposal applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

5. Establish specific class lives for utility grading costs

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in

service after 1986 are generally set forth in Revenue Procedure 87-56.[91] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

Description of Proposal

The proposal assigns a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The proposal includes these assets in the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective Date

The proposal is effective for electric and gas utility clearing and grading costs incurred after the date of enactment.

6. Repeal of ten-percent rehabilitation tax credit

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures (sec. 47).

A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

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[91] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, the building must have been substantially rehabilitated, and it must have been placed in service before the beginning of the rehabilitation. A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

Description of Proposal

The proposal provision repeals the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936. The proposal retains the present-law 20-percent credit for rehabilitation expenditures with respect to a certified historic structure.

Effective Date

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

7. Expansion of limitation on depreciation of certain passenger automobiles

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over five years. However, section 280F limits the annual depreciation deduction with respect to certain passenger automobiles.[92]

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[92] The limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles (subject to the such limitation) placed in service in 2002, the maximum amount of allowable depreciation is $7,660 for the year in which the vehicle was placed in service, $4,900 for the second year, $2,950 for the third year, and $1,775 for the fourth and later years. This limitation applies to the combined depreciation deduction provided under present law for depreciation, including section 179 expensing and the temporary 30 percent additional first year depreciation allowance. For luxury automobiles eligible for the 50% additional first depreciation allowance the first year limitation is increased by an additional $3,050.

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[93] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sports utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment (sec. 179). The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[94] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[95] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.

Description of Proposal

The proposal limits the ability of taxpayers to claim deductions under section 179 for certain vehicles not subject to section 280F to $25,000. The proposal applies to sports utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the present law 6,000 pound rating). For this purpose, a sports utility vehicle is defined to exclude any vehicle that: (1) does not have a primary load device or container attached; (2) has a seating capacity of more than 12 individuals; (3) is designed for more than nine individuals in seating rearward of the driver's seat; (4) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least 72.0 inches in interior length; or (5) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

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[93] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

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

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

Effective Date

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

8. Increase age limit under section 1(g)

Present Law

Filing requirements for children

Single unmarried individuals eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has (1) earned income only over $4,750 (for 2003), (2) unearned income only over the minimum standard deduction amount for dependents ($750 in 2003), or (3) both earned income and unearned income totaling more than the smaller of (a) $4,750 (for 2003) or (b) the larger of (i) $750 (for 2003), or (ii) earned income plus $250.[96] Thus, if a dependent child has less than $750 in gross income, the child does not have to file an individual income tax return for 2003.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income under section 1(g)

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[97] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year, (2) the child's investment income was more than $1,500 (for 2003) and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($750 for 2003), and (2) the

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[96] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 3, Table 1 (2002).

[97] Sec. 1(g).

greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[98] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income.[1] If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[99]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

<u>Parental election to include child's unearned income</u>

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[100]

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[98] Sec. 1(g)(4).

[99] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2002).

[100] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2002).

(2) such income is more than the minimum standard deduction amount for dependents ($750 in 2003) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,500 for 2003). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $75 (in 2003), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($750 in 2003).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[101] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[102] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[103]

Taxation of compensation for services under section 1(g)

Compensation for a child's services, even though not retained by the child, is considered the gross income of the child, not the parent, even if the compensation is not received by the child (e.g. is the parent's income under local law).[104] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[105]

[101] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 8 (2002).

[102] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2002).

[103] Sec. 1(g)(7)(B).

[104] Sec. 73(a).

[105] Sec. 6201(c).

Description of Proposal

The proposal increases the age of minors to which the kiddie tax provisions apply from under 14 to under 18.

Effective Date

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

9. Provide consistent amortization period for intangibles

Present Law

At the election of the taxpayer, start-up expenditures[106] and organizational expenditures[107] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[108] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

Description of Proposal

The proposal modifies the treatment of start-up and organizational expeditures. A taxpayer would be allowed to elect to deduct up to $5,000 each of start-up and organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000

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[106] Sec. 195

[107] Secs. 248 and 709.

[108] Treas. Reg. sec. 1.195-1.

amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective Date

The proposal is effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

10. Deny installment sale treatment for all readily tradable debt

Present Law

Under present law, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[109] However, the installment method is not available if the taxpayer sells property in exchange for a readily tradable evidence of indebtedness that is issued by a corporation or a government or political subdivision. Instead, the receipt of such indebtedness is treated as payment on the installment note.[110]

No similar provision under present law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

Description of Proposal

The proposal denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable under present-law rules, regardless of the nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

Effective Date

The proposal is effective for sales occurring on or after date of enactment.

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[109] Sec. 453.

[110] Sec. 453(f)(3).

11. Limitation of tax benefits for leases to certain tax exempt entities

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[111] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[112] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[113]

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Description of Proposal

The proposal limits the amount of allowable deductions or losses with respect to certain service contracts or leases to the amount of income reported with respect to each such service contract or lease.[114] The proposal applies to leases and certain service contracts and similar arrangements with a tax-exempt entity. For purposes of the proposal a tax-exempt entity is defined as the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing; an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter one of

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[111] Sec. 168(g)(3)(A).

[112] Sec. 168(h)(1).

[113] Sec. 168(h)(2).

[114] It is intended that the limitations would be similar to the passive activity loss rules of section 469.

the Code; and any foreign government, political subdivision thereof, or any agency or instrumentality of any of the foregoing.

Effective Date

The proposal is effective for leases and other similar arrangements entered into after the date of enactment.

12. Mandatory basis adjustments in connection with partnership distributions and transfers of partnership interests

Present Law

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[115] If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[116] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[117] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[118] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's

[115] Sec. 743(a).

[116] Sec. 743(b).

[117] Sec. 731(a) and (b).

[118] Sec. 732(b).

adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[119]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[120] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[121] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Description of Proposal

Under the proposal, adjustments to the basis of partnership property in the event of a partnership distribution or the transfer of a partnership interest are required, not elective as under present law. However, the basis adjustments are elective, as under present law, in the case of the transfer of a partnership interest by reason of the partner's death.

Effective Date

The proposal applies to transfers and distributions after the date of enactment.

[119] Sec. 732(a).

[120] Sec. 734(a).

[121] Sec. 734(b).

ESTIMATED REVENUE EFFECTS OF MODIFICATIONS TO THE CHAIRMAN'S MARK OF S. 1637, THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON OCTOBER 1, 2003

Fiscal Years 2004 - 2013

[Millions of Dollars]

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
The Chairman's Mark of S. 1637													
Provisions Relating to Repeal of Exclusion for Extraterritorial Income													
1. Repeal of exclusion for extraterritorial income [1]	toa DOE	3,710	4,780	5,093	5,312	5,508	5,727	5,993	6,258	6,518	6,789	24,403	55,688
2. Deduction relating to income attributable to United States production activities	tyea DOE	-339	-835	-1,609	-3,510	-4,340	-4,947	-6,094	-6,300	-7,682	-9,952	-10,633	-45,608
Total of Provisions Relating to Repeal of Exclusion for Extraterritorial Income		3,371	3,945	3,484	1,802	1,168	780	-101	-42	-1,164	-3,163	13,770	10,080
General Transition for Repeal of Exclusion for Extraterritorial Income	toa DOE & before 2007	-3,105	-3,234	-2,682	-765	---	---	---	---	---	---	-9,786	-9,786
International Tax Provisions													
A. International Tax Reform													
1. Extend the foreign tax credit carryforward from 5 years to 20 years	[2]	---	-266	-343	-412	-577	-767	-941	-1,080	-1,253	-1,453	-1,598	-7,092
2. Apply look-through rules for dividends from noncontrolled section 902 corporations	tyba 12/31/02	-585	-77	-51	-23	-6	-1	[3]	[3]	[3]	[3]	-742	-743
3. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	---	-236	-355	-338	-334	-333	-334	-338	-344	-352	-1,263	-2,964
4. Recharacterize overall domestic loss	lf tyba 12/31/06	---	---	---	-57	-680	-713	-756	-793	-829	-862	-737	-4,690
5. Interest expense allocation rules	tyba 12/31/09	---	---	---	---	---	---	-963	-2,586	-2,689	-2,797	---	-9,035
6. Determination of foreign personal holding company income with respect to transactions in commodities	tela 12/31/04	---	-4	-10	-10	-10	-10	-11	-11	-11	-11	-34	-88
B. International Tax Simplification													
1. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules	[4]	---	-25	-65	-73	-81	-91	-102	-114	-128	-143	-244	-822
2. Expand the subpart F de minimis rule to the lesser of 5% of gross income or $5 million	[4]	---	-15	-143	-157	-173	-190	-209	-230	-253	-279	-488	-1,649
3. Attribution of stock ownership through partnerships in determining section 902 and 960 credits	tyba DOE	[3]	-1	-3	-3	-3	-3	-3	-3	-3	-3	-10	-25
4. Limit application of uniform capitalization rules in the case of foreign persons	tyba 12/31/04	---	-125	-278	-79	-27	-8	-12	-14	-16	-18	-509	-577

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
5. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations	pma 12/31/04	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26
6. Eliminate 30% tax on certain U.S.-source capital gains of nonresident individuals	tyba 12/31/03	-1	-2	-2	-2	-3	-3	-3	-3	-3	-3	-10	-25
Total of International Tax Provisions		-586	-753	-1,253	-1,157	-1,897	-2,122	-3,337	-5,175	-5,532	-5,924	-5,646	-27,736
Interaction	---	13	14	16	17	19	21	245	620	646	674	79	2,285
Revenue Offset Provisions													
A. Provisions Designed to Curtail Tax Shelters													
1. Clarification of the economic substance doctrine and related penalty provisions	tela DOE	1,031	1,242	1,163	1,049	1,086	1,200	1,335	1,517	1,729	1,970	5,571	13,322
2. Provisions relating to reportable transactions and tax shelters	various dates after DOE [5]	92	115	119	120	124	131	139	150	164	179	570	1,333
3. Modification to the substantial understatement penalty	tyba DOE	---	4	11	19	23	26	30	34	38	38	57	223
4. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts	DOE	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	1	3
5. Actions to enjoin conduct with respect to tax shelters	DOE	Negligible Revenue Effect											
6. Understatement of taxpayer's liability by income tax return preparer	dpa DOE	Negligible Revenue Effect											
7. Frivolous tax submissions	[7]	3	3	3	3	3	3	3	3	3	3	15	30
8. Regulation of individuals practicing before the Department of Treasury	ata DOE	No Revenue Effect											
9. Extend statute of limitations for undisclosed listed transactions	[8]	---	---	1	1	1	1	1	1	1	1	3	8
10. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions	tyba DOE	---	---	1	1	3	4	4	4	4	4	5	25
11. Authorize additional $300 million per year to the IRS to combat abusive tax avoidance transactions [9]	DOE	No Revenue Effect											
Total of Provisions Designed to Curtail Tax Shelters		1,126	1,364	1,298	1,193	1,240	1,365	1,512	1,709	1,939	2,195	6,222	14,944
B. Other Corporate Governance Provisions													
1. Affirmation of consolidated return regulation authority	[10]	Negligible Revenue Effect											
2. Chief executive officer required to sign declaration as part of corporate income tax return	rfa DOE	Negligible Revenue Effect											
3. Denial of deduction for certain fines, penalties, and other amounts	apoia 4/27/03	101	10	10	10	10	10	10	10	10	10	141	191
4. Denial of deduction for punitive damages	dpoia DOE	38	29	30	31	32	33	34	35	36	37	160	333
5. Criminal tax fraud package	oco/a DOE	---	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	5
Total of Other Corporate Governance Provisions		139	39	40	41	42	43	44	45	46	47	301	529
C. Enron-Related Tax Shelter Provisions													
1. Limitation on transfer or importation of built-in losses	ta 2/13/03	128	123	136	149	164	180	198	218	240	264	700	1,800
2. No reduction of basis under section 734 in stock held by partnership in corporate partner	da 2/13/03	9	13	20	28	36	44	51	54	56	57	105	368
3. Repeal of special rules for FASITs	after 2/13/03	Negligible Revenue Effect											
4. Expanded disallowance of deduction for interest on convertible debt	dlia 2/13/03	6	88	90	94	96	98	101	103	106	109	374	891

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
5. Expanded authority to disallow tax benefits under section 269	aa 2/13/03	10	9	9	10	10	11	11	12	12	13	48	108
6. Modification of CFC-PFIC coordination rules	[11]	23	15	8	4	5	6	8	10	12	15	55	106
Total of Enron-Related Tax Shelter Provisions		176	248	263	285	311	339	369	397	426	458	1,282	3,273
D. Tax Treatment of Inversion Transactions	[12]	172	137	140	168	202	242	290	348	418	493	819	2,610
E. Impose Mark-to-Market on Individuals who Expatriate	[13]	101	84	80	74	71	67	61	57	54	51	410	700
F. Other Revenue Provisions													
1. Effectively connected income to include certain foreign-source income	tyba DOE	3	5	7	8	9	10	10	10	10	11	32	83
2. Recapture of overall foreign losses on sale of controlled foreign corporation stock	DOE	[6]	3	7	8	9	9	9	10	10	10	27	75
3. Disallowance of partnership loss transfers	ctada DOE	15	39	57	70	79	84	86	89	91	94	261	705
4. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds	padoa DOE	2	13	11	8	5	3	[6]	[6]	[6]	[6]	39	42
5. Minimum holding period for foreign tax credit on withholding tax on income other than dividends	apoamt30da DOE	[6]	3	3	3	3	4	4	4	4	5	12	33
6. Modify treatment of transfers to creditors in divisive reorganizations	to/a DOE	[6]	8	9	10	10	10	11	11	12	12	37	93
7. Extend present-law intangibles amortization provisions to acquisitions of sports franchises	aoa DOE	13	61	94	68	36	23	21	19	22	24	272	381
8. Clarification of rules for payment of estimated tax for certain deemed asset sales	toa DOE	51	37	10	3	3	3	3	4	4	5	104	123
9. Extension of IRS user fees (through 9/30/13) [9]	rma DOE	33	34	35	36	38	39	41	42	44	45	176	386
10. Double certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements	oyo/a DOE	2	1	1	[14]	[14]	[14]	[14]	[14]	[14]	[14]	4	6
11. Add vaccines against Hepatitis A to the list of taxable vaccines [15]	[16]	6	9	9	9	9	9	9	9	9	9	42	87
12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence	sopra DOE	[6]	11	13	15	17	19	21	23	25	27	56	171
13. Authorize IRS to enter into installment agreements that provide for partial payment	iaeio/a DOE	40	14	5	[6]	[6]	[6]	[6]	[6]	[6]	[6]	60	63
14. Lease term to include certain service contracts	leia DOE	14	26	41	57	74	92	110	129	150	171	212	864
Total of Other Revenue Provisions		179	264	302	295	292	305	325	350	381	413	1,334	3,112
Total of Revenue Offset Provisions		1,893	2,136	2,123	2,056	2,158	2,361	2,601	2,906	3,264	3,657	10,368	25,168
Total of the Chairman's Mark of S. 1637		1,586	2,108	1,688	1,953	1,448	1,040	-592	-1,691	-2,786	-4,756	8,785	11
Additional Provisions to be Included in S. 1637													
Other Provisions													
A. International Provisions													
1. Subpart F exception for active aircraft and vessel leasing income	[17]	---	---	---	-46	-187	-237	-289	-333	-382	-440	-233	-1,914
2. Look-through treatment of payments between related CFCs under foreign personal holding company rules	[18]	---	-72	-203	-219	-239	-245	-272	-292	-314	-337	-733	-2,193

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
3. Look-through treatment under subpart F for sales of partnership interests	[18]	---	-39	-91	-96	-101	-106	-111	-116	-122	-129	-327	-911
4. Election not to use average exchange rate for foreign tax paid other than in functional currency	tyba 12/31/04	Negligible Revenue Effect											
5. Revision of foreign tax credit basket rules with respect to "base differences"	tyea DOE	-4	-14	-15	-17	-19	-21	-24	-27	-30	-34	-69	-205
6. Modification of exceptions under subpart F for active financing income	[18]	Negligible Revenue Effect											
7. United States property not to include certain assets of controlled foreign corporations	[18]	---	-3	-20	-21	-22	-23	-24	-25	-27	-29	-66	-194
8. Provide equal treatment for interest paid by foreign partnerships and foreign corporations doing business in the U.S.	tyba 12/31/03	-1	-2	-2	-2	-2	-2	-2	-2	-3	-3	-9	-21
9. Foreign tax credit treatment of deemed payments under section 367(d)	aro/a 8/5/97	-22	-4	-5	-5	-5	-5	-5	-5	-5	-5	-41	-66
10. Modify FIRPTA rules for REITs	tyba DOE	-3	-5	-7	-10	-12	-14	-15	-17	-19	-21	-38	-124
11. Temporary rate deduction for certain dividends received from controlled foreign corporations	[19]	2,713	146	-2,511	-1,376	-903	-599	-413	-327	-288	-211	-1,931	-3,769
12. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals	wma DOE	-1	-2	-3	-3	-3	-3	-3	-3	-3	-3	-12	-26
13. Require Commerce Department report on adverse decisions of the World Trade Organization	after DOE	No Revenue Effect											
14. Consultative role for the Committee on Finance in connection with the review of proposed tax treaties	DOE	No Revenue Effect											
15. Study of impact of international tax law on taxpayers other than large corporations	after DOE	No Revenue Effect											
16. Modifications to Existing Provisions													
a. Accelerate effective date of 20-year foreign tax credit carryforward period, and limit carrybacks to 1 year	[20]	-165	52	72	74	77	81	83	85	87	90	110	536
b. Clarification of 10-50 look-thru	[4]	Negligible Revenue Effect											
c. Interest allocation rule effective in 2009	tyba 12/31/08	---	---	---	---	---	-908	-1,524	---	---	---	---	-2,432
Total of International Provisions		2,517	57	-2,785	-1,721	-1,416	-2,082	-2,599	-1,062	-1,106	-1,122	-3,349	-11,319
B. Domestic Manufacturing and Business Provisions													
1. Modifications to qualified small issue bonds - increase capital expenditure limit from $10 to $20 million (maximum bond limit remains at $10 million)	bia DOE	-3	-9	-16	-22	-29	-35	-42	-48	-54	-60	-78	-317
2. Expensing of investment in broadband equipment (sunset 12/31/04)	ppisa 12/31/03	-157	-65	27	23	20	18	17	15	13	13	-151	-75
3. Change the definition of "production period" with regard to the natural aging process for distilled liquors for purposes of the capitalization rules under section 263A	ppba DOE	-25	-50	-44	-32	-20	-7	-1	-1	-1	-1	-169	-181
4. Section 355 "active business test" applied to chains of affiliated corporations	generally da DOE	-6	-7	-7	-7	-8	-8	-9	-9	-10	-11	-35	-82
5. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness	[21]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
6. Modified taxation of imported archery products	asbmpoia 12/31/03	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
7. Modify cooperative marketing to include value-added processing involving animals	tyba DOE	-1	-3	-4	-5	-6	-7	-9	-10	-11	-13	-19	-69

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
8. Extend declaratory judgment relief to farm cooperatives	pfa DOE	Revenue Effects Included in Line Above											
9. Repeal personal holding company tax (sunset after 2008)	tyba 12/31/03	-87	-164	-171	-174	-178	-81	---	---	---	---	-774	-855
Total of Domestic Manufacturing and Business Provisions		-281	-300	-217	-219	-223	-122	-46	-55	-65	-74	-1,234	-1,597
C. Manufacturing Relating to Films													
1. Special rules for certain film and television production (sunset taxable years beginning after 2008)	tyba DOE	-112	-264	-348	-326	-231	-7	239	349	306	157	-1,281	-237
2. Inclusion of certain trademarks and coyprights as qualified production property	tyea DOE	-1	-3	-7	-14	-18	-21	-28	-32	-36	-41	-43	-201
Total of Manufacturing Relating to Films		-113	-267	-355	-340	-249	-28	211	317	270	116	-1,324	-438
D. Manufacturing Relating to Timber													
1. Deduction of the first $10,000 of qualified reforestation costs	epoia DOE	-21	-51	-39	-27	-14	-2	3	9	14	22	-152	-106
2. Election to treat cutting of timber as sale or exchange	DOE	-1	-2	-4	-8	-11	-12	-16	-19	-21	-24	-26	-120
3. Permit capital gain treatment for outright sales of timber by landowner	sota DOE	Negligible Revenue Effect											
4. Modified safe-harbor rules for timber REITs	tyba DOE	[22]	[22]	-1	-1	-2	-3	-3	-4	-4	-5	-4	-23
5. Modification of application of the income forecast method of accounting	ppisa DOE	-157	-132	-86	-43	-27	-23	-25	-28	-31	-35	-445	-587
Total of Manufacturing Relating to Timber		-179	-185	-130	-79	-54	-40	-41	-42	-42	-42	-627	-836
E. Modifications to Existing Manufacturing Deduction													
1. Extend manufacturer deduction to softwood timber	tyea DOE	-4	-9	-17	-37	-46	-52	-64	-67	-81	-105	-113	-482
2. Extend manufacturer deduction to partnerships and sole proprietors (include anti-abuse rules including 50% of wages cap)	tyea DOE	-15	-107	-285	-545	-748	-968	-1,103	-1,078	-1,144	-1,204	-1,700	-7,197
3. Phaseout the domestic/foreign haircut beginning in 2010	tyea DOE	---	---	---	---	---	---	-529	-1,551	-1,267	-245	---	-3,592
4. Extend manufacturer deduction to oil refining	tyea DOE	-18	-49	-98	-209	-263	-305	-399	-461	-521	-589	-637	-2,912
Total of Modifications to Existing Manufacturing Deduction		-37	-165	-400	-791	-1,057	-1,325	-2,095	-3,157	-3,013	-2,143	-2,450	-14,183
Total of Other Provisions		1,907	-860	-3,887	-3,150	-2,999	-3,597	-4,570	-3,999	-3,956	-3,265	-8,984	-28,373
Additional Revenue Offsets													
A. International Provisions													
1. Clarification of banking business for determining investment of earnings in U.S. property	DOE	---	9	17	17	18	19	20	21	22	23	61	166
2. Prohibition on nonrecognition of gain through complete liquidation of holding company	doo/a DOE	[6]	13	15	17	19	21	23	25	27	29	64	189
3. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons	pao/a DOE	12	41	84	79	33	35	37	39	41	43	249	444
4. Apply earnings-stripping rules to partnerships and S corporations	tybo/a DOE	3	18	21	22	25	27	29	31	33	35	89	244
5. Excise tax on stock compensation of insiders in inverted corporations	generally 7/11/02	15	10	10	10	10	10	10	10	10	10	55	105
6. Reinsurance agreements	rra 4/11/02	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	2	5
7. Reporting of taxable mergers and acquisitions	aa DOE	1	2	3	3	3	3	3	3	3	3	12	27
Total of International Provisions		31	93	150	148	108	115	122	129	136	143	532	1,180

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
B. Corporate and Financial Products													
1. Modify qualification rules for tax-exempt property and casualty insurance companies	tyba 12/31/03	49	107	120	126	131	137	142	148	154	160	534	1,273
2. Recognize cancellation of indebtedness income realized on satisfaction of debt with partnership interest [23]	colo/a DOE	3	4	4	4	4	5	5	5	5	6	19	45
3. Modification of the straddle rules	peo/a DOE	5	17	19	21	24	26	28	29	30	31	86	230
4. Clarify definition of nonqualified preferred stock	ta 5/14/03	[6]	5	8	8	8	8	8	8	7	7	29	67
Total of Corporate and Financial Products		57	133	151	159	167	176	183	190	196	204	668	1,615
C. Other Revenue Offsets													
1. Definition of controlled group of corporations	tyba DOE	3	6	5	4	3	2	2	2	1	1	21	29
2. Provide that deductions for charitable contributions of patents or similar property may not exceed the donor's basis; provide that donor may receive a right to certain payments by the donee	cma 10/1/03	236	356	366	377	389	400	412	425	438	451	1,725	3,851
3. Extension of Customs User Fees													
a. Extend passenger and conveyance processing fee through 9/30/13 [9]	DOE	273	377	396	416	437	459	482	507	531	558	1,899	4,436
b. Extend merchandise processing fee through 9/30/13 [9]	DOE	992	1,042	1,094	1,149	1,206	1,266	1,330	1,396	1,466	1,539	5,483	12,480
4. Deposits to stop the running of interest on potential underpayments	dma DOE	157	-5	-6	-6	-6	-6	-7	-7	-7	-7	134	101
5. Establish specific class lives for utility grading costs	cia DOE	3	14	34	56	73	86	96	107	114	117	182	701
6. Repeal the 10% rehabilitation credit for non-historic buildings	eii tyba 12/31/03	54	74	79	89	97	106	116	123	134	144	390	1,013
7. Expansion of depreciation limits on certain passenger automobiles	ppisa DOE	43	75	76	38	-46	-102	-57	-25	-3	---	187	---
8. Increase age limit for section 1(g)	tyba 12/31/03	34	88	97	109	117	120	123	139	168	185	445	1,180
9. Provide consistent amortization periods for intangibles	[24]	-112	214	442	518	552	443	398	342	282	212	1,614	3,291
10. Deny installment sale treatment for all readily tradable debt	soo/a DOE	13	51	57	8	11	12	13	15	17	18	140	215
11. Limitation of tax benefits for lessors to certain tax-exempt entities	leia DOE	8	16	25	34	44	55	66	78	90	103	127	519
12. Mandatory basis adjustment of partnership property in the case of property transfer or distributions except for transfers by reason of death	ctada DOE	---	1	2	3	4	4	5	4	5	5	9	32
Total of Other Revenue Offsets		1,704	2,309	2,667	2,795	2,881	2,845	2,979	3,106	3,236	3,326	12,356	27,848
Total of Additional Revenue Offsets		1,792	2,535	2,968	3,102	3,156	3,136	3,284	3,425	3,568	3,673	13,556	30,643
Reserve for Possible Interaction Effects and Other Adjustments		---	---	---	---	---	---	---	---	---	---	---	-2,000
Total of Additional Provisions to be Included in S. 1637		3,699	1,675	-919	-48	157	-461	-1,286	-574	-388	408	4,572	270
NET TOTAL		5,285	3,783	769	1,905	1,605	579	-1,878	-2,265	-3,174	-4,348	13,357	281

Joint Committee on Taxation

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

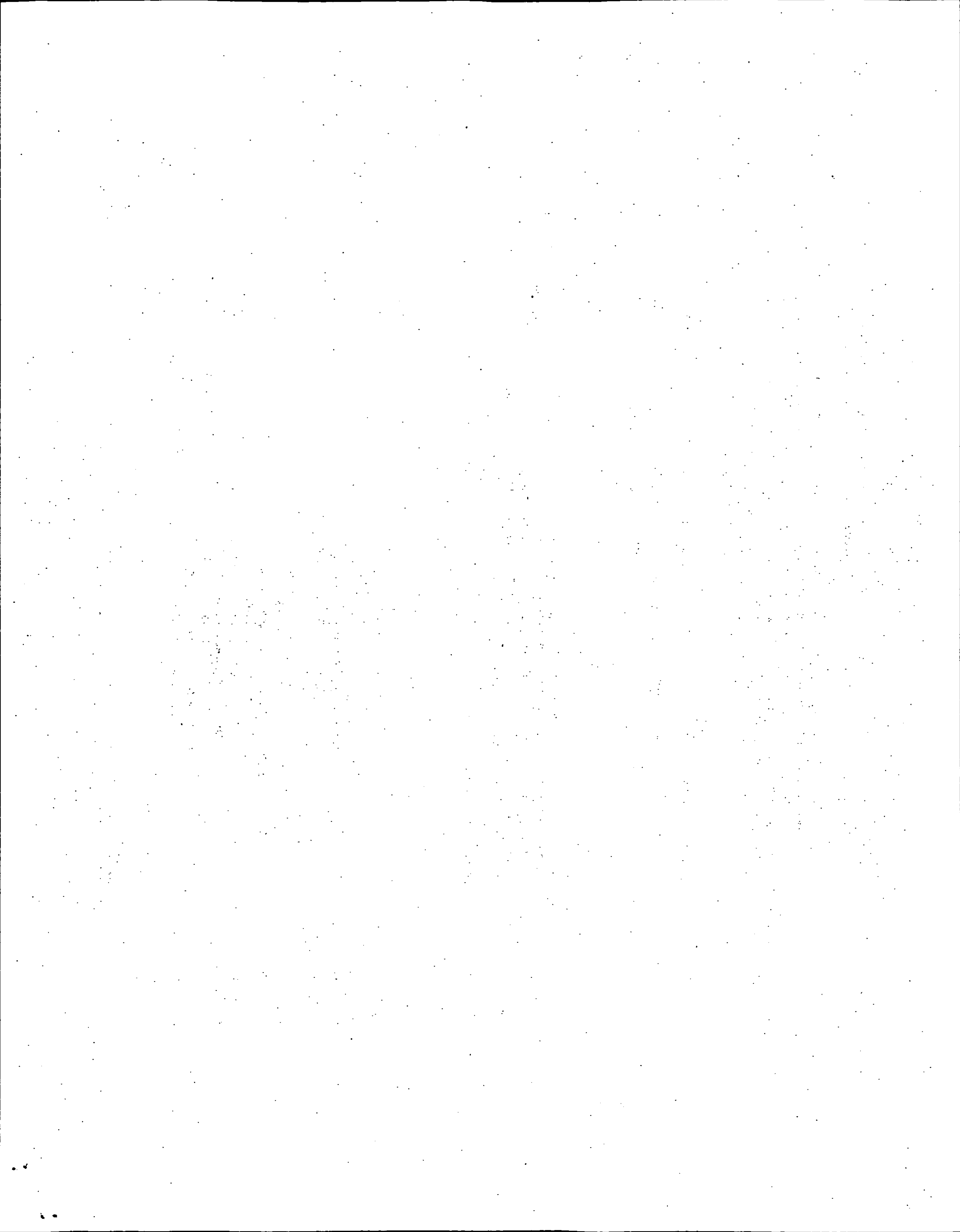
[Legend and Footnotes for JCX-86-03 appear on the following page]

Legend and Footnotes for JCX-86-03:

Legend for "Effective" column:

aa = acquisitions after
aoa = acquisitions occurring after
apoamt30da = amounts paid or accrued more than 30 days after
apoia = amounts paid or incurred after
aro/a = amounts received on or after
asbmpoia = articles sold by the manufacturer, producer, or importer after
ata = actions taken after
bia = bonds issued after
cia = costs incurred after
cma = contributions made after
coio/a = cancellations of indebtedness on or after
ctada = contributions, transfers, and distributions after
da = distributions after
diia = debt instrument issued after
dma = deposits made after
DOE = date of enactment
doo/a = distributions occurring on or after
dpa = documents prepared after
dpoia = damages paid or incurred after
eii = expenses incurred in
epoia = expenditures paid or incurred after
iaeio/a = installment agreements entered into on or after
leia = leases entered into after
lf = losses for
oco/a = offenses committed on or after
oyo/a = open years on or after
padoa = purchases and dispositions occurring after
pao/a = payments accrued on or after
peo/a = positions established on or after
pfa = pleadings filed after
pma = payments made after
ppba = production periods beginning after
ppisa = property placed in service after
rfa = returns filed after
rma = requests made after
rra = risk reinsured after
sota = sales of timber after
soo/a = sales occurring on or after
sopra = sales of principal residences after
ta = transactions after
teia = transactions entered into after
toa = transactions occurring after
to/a = transactions on or after
tyba = taxable years beginning after
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
wma = wagers made after

[1] Includes estimate for binding contract relief.
[2] Effective for excess foreign taxes that may be carried forward to any taxable year beginning after December 31, 2004.
[3] Loss of less than $1 million.
[4] Effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. persons owning stock of such corporations with or within such corporations' taxable years end.
[5] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the material advisor and investor list disclosure provisions applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the failure to register tax shelter penalty applies to returns the due date for which is after the date of enactment; the investor list penalty applies to requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.
[6] Gain of less than $1 million.
[7] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[8] Effective for taxable years with respect to which the period for assessing deficiencies did not expire before October 1, 2003.
[9] Estimate provided by the Congressional Budget Office.
[10] Effective for all taxable years, whether beginning before, with, or after the date of enactment.
[11] Effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and to taxable years of U.S. shareholders in which or with which such taxable years of controlled corporations end.
[12] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002.
[13] Generally effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after February 5, 2003.
[14] Gain of less than $500,000.
[15] Estimate contains outlay effects that will be provided by the Congressional Budget Office.
[16] Effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.
[17] Effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders ending with or within such taxable years of such foreign corporations.
[18] Effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders ending with or within such taxable years of such foreign corporations.
[19] Effective for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment.
[20] Effective for credits that can be carried to taxable years ending after date of enactment. Revision of carryback period effective for credits arising in taxable years beginning after the date of enactment.
[21] Effective for debt incurred by a small business investment company after December 31, 2003, with respect to property acquired after such date.
[22] Loss of less than $500,000.
[23] Estimate is preliminary and subject to change pursuant to the receipt of additional information.
[24] Generally effective for start-up and organizational expenditures incurred after the date of enactment.



Joint Committee on Taxation
October 1, 2003
JCX-87-03

ADDITIONAL MODIFICATIONS TO THE CHAIRMAN'S MARK OF S. 1637, THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT," SCHEDULED FOR MARKUP BY THE SENATE COMMITTEEE ON FINANCE ON OCTOBER 1, 2003[1]

The following additional proposals would be included in the Chairman's Mark:

A. Increase Section 179 Expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[2] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[3] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable

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[1] This document may be cited as Joint Committee on Taxation, *Additional Modifications to the Chairman's Mark of S. 1637, the "Jumpstart Our Business Strength ('JOBS') Act," Scheduled for Markup by the Senate Committee on Finance on October 1, 2003* (JCX-87-03), October 1, 2003.

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

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

year exceeds $200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

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

Description of Proposal

The proposal provides that the $100,000 amount ($25,000 for taxable years beginning in 2006 and thereafter) is reduced (but not below zero) by only one half of the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000 ($200,000 for taxable years beginning 2006 and thereafter).

Effective Date

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

B. Three-Year Carryback of Net Operating Losses

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[4] Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction).

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[4] Sec. 172.

Section 202 of the Job Creation and Worker Assistance Act of 2002[5] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.[6]

JCWAA also provided that an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, may offset 100 percent of a taxpayer's AMTI.[7]

Description of Proposal

The proposal provides for a three-year carryback of NOLs for NOLs arising in taxable years ending in 2003.[8]

The proposal also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2003 as well as NOL carryforwards to these taxable years, to offset 100 percent of a taxpayer's AMTI.

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[5] Pub. Law No. 107-147.

[6] Because JCWAA was enacted after some taxpayers had filed tax returns for years affected by the provision, a technical correction is needed to provide for a period of time in which prior decisions regarding the NOL carryback may be reviewed. Similarly, a technical correction is needed to modify the carryback adjustment procedures of sec. 6411 for NOLs arising in 2001 and 2002. These issues were addressed in a letter dated April 15, 2002, sent by the Chairmen and Ranking Members of the House Ways and Means Committee and Senate Finance Committee, as well as in guidance issued by the IRS pursuant to the Congressional letter (Rev. Proc. 2002-40, 2002-23 I.R.B. 1096, June 10, 2002).

[7] Section 172(b)(2) should be appropriately applied in computing AMTI to take proper account of the order that the NOL carryovers and carrybacks are used as a result of this provision. *See* section 56(d)(1)(B)(ii).

[8] Because certain taxpayers may have already filed tax returns (or be in the process of filing tax returns) for taxable years ending in 2003, the proposal contains special rules to provide until November 1, 2003 in which prior decisions regarding the NOL carryback may be reviewed by taxpayers.

Effective Date

The three-year carryback proposal is effective for net operating losses generated in taxable years ending in 2003. The proposal relating to AMTI is effective for NOL carrybacks arising in, and NOL carryforwards to, taxable years ending in 2003.

C. Qualified Tax Collection Contracts

Present Law

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes.[9] The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[10] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot.

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[11]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[12] That provision does not apply to the collection of debts under the Internal Revenue Code.[13]

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[9] Sec. 7801(a).

[10] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

[11] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.

[12] 31 U.S.C. sec. 3718.

[13] 31 U.S.C. sec. 3718(f).

On February 3, 2003, the President submitted to the Congress his fiscal year 2004 budget proposal,[14] which proposed the use of private debt collection companies to collect Federal tax debts.

Description of Proposal

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities[15] of any type[16] and to arrange payment of those taxes by the taxpayers. Several steps are involved. First, the private debt collection company contacts the taxpayer by letter.[17] If the taxpayer's last known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[18] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as three years. If the taxpayer is unable to pay the outstanding tax liability in full over a three-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The proposal specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. Third, the private sector debt collection companies are required to inform taxpayers of the availability of assistance from the Taxpayer Advocate. Fourth, subcontractors are prohibited from having

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[14] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004* (H. Doc. 108-3, Vol. I), p. 274.

[15] There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability.

[16] The bill generally applies to any type of tax imposed under the Internal Revenue Code. It is anticipated that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[17] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to 6103 is necessary to implement the provision. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

[18] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS.

The proposal creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The bill prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[19]

Effective Date

The proposal is effective on the date of enactment.

[19] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.