CONTENTS

I. CONSERVATION

A. Residential and Business Property

1. Residential solar hot water, photovoltaics and other energy efficient property (sec. 41001 of the House bill, sec. 2103 of the Senate amendment, and new sec. 25C of the Code)

Present Law

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

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

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

House Bill

The provision provides a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 15 percent of qualified investment up to a maximum credit of $2,000 for solar water heating property and $2,000 for rooftop photovoltaic property. This credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit.

Qualifying solar water heating property is property that heats water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations.

Effective date.–The credit applies to purchases in taxable years ending after December 31, 2003 and before January 1, 2007 (January 1, 2009 in the case of qualified photovoltaic property).

Senate Amendment

The Senate amendment includes the provisions of the House bill. Additionally, the Senate amendment adds a 30-percent credit for qualified wind energy property, up to a maximum credit of $2,000. Qualified wind energy property is property that uses wind energy to generate electricity for use in a dwelling unit.

The Senate amendment also provides a 100 percent credit, with caps, for the purchase of other qualified energy efficient property, as described below.

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

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

Advanced natural gas furnaces that achieve a 95 percent annual fuel utilization efficiency. The maximum credit is $250 per unit.

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

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

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

With the exception of wind energy property, if less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Effective date.–The credit applies to purchases after December 31, 2002, and before January 1, 2008.

Conference Agreement

The conference agreement generally follows the House bill with respect to residential solar and photovoltaic property. With respect to wind energy property, the conference agreement follows the Senate amendment with two modifications. First, the credit rate is reduced to 15 percent. Second, with respect to property a portion of which is used in business, the taxpayer may choose either to claim the personal credit, or to claim depreciation for the business use portion of the property, but not both. The conference agreement clarifies that the $2,000 credit cap that applies to solar, photovoltaic, and wind energy property applies across all taxable years. Thus, with respect to a given dwelling, a taxpayer can claim at most $2,000 in credits for solar water heating property, $2,000 for photovoltaic property, and $2,000 for wind energy property. The conference agreement also clarifies that no section 45 credit may be claimed with respect to any electricity produced from property for which a residential energy efficient property credit has been claimed.

The conference agreement does not follow the Senate amendment with respect to all other energy efficient property.

It is intended under the conference agreement that availability of the credit for photovoltaic and wind energy property would not be impacted by any net-metering or net-billing arrangements under which the taxpayer sells excess electricity back to a utility. It is also intended that expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of qualifying property and for piping or wiring to interconnect such property to the dwelling unit can be taken into account for determining the amount of the credit.

Effective date.–The credit applies to purchases in taxable years ending after December 31, 2003, and before January 1, 2007 (January 1, 2009, in the case of qualified photovoltaic property).

2. Credit for electricity produced from certain sources (sec. 41002 of the House bill, secs. 1901, 1902, 1903, 1904, 1905, and 1906 of Senate amendment, and sec. 45 of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt-hour for 2003. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

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

House Bill

Extension of placed in service date for existing facilities

The House bill extends the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992, in the case of closed-loop biomass facilities) and before January 1, 2007. The House bill does not extend the placed in service date for poultry waste facilities.

Additional qualifying facilities

The House bill also defines three new qualifying facilities: open-loop biomass facilities, landfill gas facilities, and trash combustion facilities. Open-loop biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying open-loop biomass facilities and qualifying landfill gas facilities include facilities used to produce electricity placed in service before January 1, 2007. Qualifying trash combustion facilities include facilities placed in service after the date of enactment and before January 1, 2007.

In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer may claim the section 45 production credit for only five years, commencing on the date of enactment. In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer may claim two-thirds of the otherwise allowable credit for electricity produced at the facility.

Credit claimants and treatment of other subsidies

In the case of qualifying open-loop biomass facilities originally placed in service on or before the date of enactment, a lessee or operator may claim the credit in lieu of the owner of the qualifying facility. In addition, for such facilities, any reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits cannot exceed 50 percent.

Alternative minimum tax

In the case of wind facilities placed in service after the date of enactment, the taxpayer may claim credit for electricity production against both the taxpayer's regular tax and the taxpayer's alternative minimum tax, if any, for electricity produced during the first four years of production measured from the date on which the facility is placed in service.

No facility that previously claimed or currently claims credit under section 29 of the Code is a qualifying facility for purposes of section 45.

Effective date.–The provision is effective for electricity sold from qualifying facilities after the date of enactment.

Senate Amendment

Extension of placed in service date for existing facilities

The Senate amendment extends the placed in service date for wind facilities, closed-loop biomass facilities, and poultry waste facilities to facilities placed in service after December 31, 1993 (December 31, 1992, in the case of closed-loop biomass facilities and December 31, 1999, in the case of poultry waste facilities) and before January 1, 2007.

Additional qualifying facilities

The Senate amendment also defines seven new qualifying energy resources: open-loop biomass, swine and bovine waste nutrients, geothermal energy, solar energy, municipal biosolids, recycled sludge, and small irrigation.

Open-loop biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill residues, precommercial thinnings, slash, and brush, but not including old-growth timber (other than old growth timber that has been permitted or contracted for removal by appropriate Federal authority under the National Environmental Policy Act or appropriate State law authority). Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled.

Swine and bovine waste nutrients are defined as swine and bovine manure and litter, including bedding material for the disposition of manure.

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

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

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

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is less than five megawatts.

Qualifying open-loop biomass facilities are facilities using open-loop biomass to produce electricity that are placed in service prior to January 1, 2005. Qualifying swine and bovine waste nutrient facilities are facilities using swine and bovine waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying municipal biosolids facilities are facilities using municipal biosolids to generate electricity that are originally placed in service after December 31, 2001, and before January 1, 2007. Qualifying recycled sludge facilities are facilities using recycled sludge to generate electricity that are originally placed in service before January 1, 2007. Qualifying small irrigation power facilities are facilities using small irrigation power systems to generate electricity that are originally placed in service after the date of enactment and before January 1, 2007.

In the case of qualifying open-loop biomass facilities, taxpayers may claim the otherwise allowable credit for a three-year period. For a facility placed in service after the date of enactment, the three-year period commences when the facility is placed in service. In the case of open-loop biomass facility originally placed in service before the date of enactment, the three-year period commences after December 31, 2002, and the otherwise allowable 1.5 cent-per-kilowatt-hour credit (adjusted for inflation) is reduced to 1.0 cent-per-kilowatt-hour credit (adjusted for inflation). In the case of qualifying geothermal energy and solar energy facilities, taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility is placed service. In the case of electricity generated from a recycled sludge facility the 10-year credit period shall begin no earlier than the date of enactment.

In addition, the Senate amendment modifies present law to provide that qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992 and modified to use closed-loop biomass to co-fire with coal before January 1, 2007. The taxpayer may claim credit for all electricity produced at such qualifying facilities with no reduction for the thermal value of the coal.

<u>Credit claimants and treatment of other subsidies</u>

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

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

The Senate amendment repeals the present-law reduction in allowable credit for facilities financed with tax-exempt bonds or with certain loans received under the Rural Electrification Act of 1936.

Effective date.–The Senate amendment is generally is effective for electricity sold from qualifying facilities after the date of enactment. For electricity produced from qualifying open-loop biomass facilities originally placed in service prior to the date of enactment, the provision is effective January 1, 2003.

Conference Agreement

Extension of placed in service date for existing facilities

The conference agreement extends the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992, in the case of closed-loop biomass facilities) and before January 1, 2007.

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

Additional qualifying resource and facilities

The conference agreement also defines five new qualifying resources: open-loop biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, and municipal solid waste. Two different qualifying facilities use municipal solid waste as a qualifying resource: landfill gas facilities and trash combustion facilities.

Qualifying open-loop biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2007. Qualifying agricultural livestock waste nutrient facilities are facilities using agricultural livestock waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007.[1] The installed capacity of a qualified agricultural livestock waste nutrient facility is not less than 150 kilowatts.

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[1] The provision deletes poultry litter as a separate qualifying facility for facilities placed in service after the effective date. Poultry litter facilities remain qualifying facilities as agricultural waste nutrient facilities. Any poultry litter facility placed in service on or prior to December 31, 2003, is unaffected by the modifications made by this provision. For example, the value of the credit that may be claimed for production from such a facility would not be reduced by one-third as would be the case for other animal waste nutrient facilities.

Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. A qualifying geothermal energy facility or solar energy facility may not have claimed any credit under sec. 48 of the Code.[2]

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is not less than 150 kilowatts and less than five megawatts.

Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying landfill gas facilities and qualifying trash combustion facilities include facilities used to produce electricity placed in service after the date of enactment and before January 1, 2007.

Credit period and credit rates

In general, as under present law, taxpayers may claim the credit at a rate of 1.5 cents per kilowatt-hour (indexed for inflation and currently 1.8 cents per kilowatt-hour) for 10 years of production commencing on the date the facility is placed in service. In the case of open-loop biomass facilities, (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, landfill gas facilities, and trash combustion facilities the 10-year credit period is reduced to five years commencing on the date the facility is placed in service. In general, for facilities placed in service prior to January 1, 2004, the credit period commences on January 1, 2004. In the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period shall begin no earlier than the date of enactment.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrients), small irrigation power, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is reduced by one third.

Credit claimants and treatment of other subsidies

A lessee or operation may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities originally placed in service on or before the date of enactment and in the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass.

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[2] If a geothermal facility or solar facility claims credit for any year under section 45 of the Code, the facility is precluded from claiming any investment credit under section 48 of the Code in the future.

In addition, for all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, any reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits cannot exceed 50 percent. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

No facility that previously claimed or currently claims credit under section 45K of the Code (as amended by the conference agreement)[3] is a qualifying facility for purposes of section 45.

Alternative minimum tax

In the case of qualifying facilities placed in service after the date of enactment, the taxpayer may claim credit for electricity production against both the taxpayer's regular tax and the taxpayer's alternative minimum tax, if any, for electricity produced during the first four years of production measured from the date on which the facility is placed in service.

GAO study

The conference agreement directs the Comptroller General of the United States to conduct a study of the market viability of producing electricity from resources qualifying for the section 45 production credit (as amended by the conference agreement). The conferees seek a comparison of the cost of producing electricity from the various qualifying resources compared to the cost of producing electricity from fossil fuels (*i.e.*, coal, oil, and natural gas) using the latest generation of production technology currently in service in the United States. The cost of producing electricity should be reported, on a per kilowatt-hour basis, both as the incremental cost of production from a facility and on a fully-amortized cost basis assuming capital costs are amortized over the useful life of the property. In the case of facilities using open-loop biomass and municipal solid waste resources, the measurement of costs should take into account the avoided costs of waste disposal for which taxpayers otherwise would be responsible. The study is to estimate the dollar value of the environmental impact of producing electricity from qualifying resources compared to fossil fuels. The Comptroller General is to report his findings to the Committee on Ways and Means and Committee on Finance not later than June 30, 2006.

Effective date.–The provision is effective for electricity produced and sold from qualifying facilities after the date of enactment.

[3] The conference agreement modifies present-law section 29 as described below and moves present-law section 29 to new Code section 45K.

3. Tax incentives for fuel cells (sec. 41003 of the House bill, secs. 2103 and 2104 of the Senate amendment, and sec. 48 and new sec. 25C of the Code)

Present Law

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

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

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

House Bill

The provision provides a 10-percent credit for the purchase of qualified fuel cell power plants for businesses and individuals. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent. The credit may not exceed $500 for each 0.5 kilowatt of capacity. For individuals, the qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a residence. The credit is nonrefundable. The taxpayer’s basis in the property is reduced by the amount of the credit claimed.

<u>Effective date</u>.–The credit for businesses applies to property placed in service after December 31, 2003, and before January 1, 2007, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990). The credit for individuals applies to expenditures made after December 31, 2003, and before January 1, 2007.

Senate Amendment

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

The proposal also provides a 30-percent credit for individuals for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $1,000 for each kilowatt of capacity. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

Additionally, the Senate amendment provides a 10-percent credit for the purchase of qualifying stationary microturbine power plants. A qualified stationary microturbine power plant is a system comprising a rotary engine that is actuated by the aerodynamic reaction or impulse or both on radial or axial curved full-circumferential-admission airfoils on a central axial rotating spindle. Such system must have an electricity-only generation efficiency of not less that 26 percent at International Standard Organization conditions. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

Effective date.–The credit for businesses applies to property placed in service after December 31, 2002, and before January 1, 2008 (January 1, 2007, in the case of microturbines), under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990). The credit for individuals applies to expenditures made after December 31, 2002, and before January 1, 2008

Conference Agreement

The conference agreement follows the House bill with the modification that the credit rate is increased to 20 percent.

Effective date.–The provision applies to periods after December 31, 2003, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990), for property placed in service before January 1, 2007. The credit for individuals applies to expenditures made after December 31, 2003, and before January 1, 2007.

4. Energy efficient improvements to existing homes (secs. 41004 of the House bill, sec. 2109 of the Senate amendment, and new sec. 25D of the Code)

Present Law

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

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

House Bill

The provision provides a 20-percent nonrefundable credit for the purchase of qualified energy efficiency improvements. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is $2,000. A qualified energy efficiency improvement is any energy efficiency building envelope component that is certified (in the case of expenditures that exceed $1,000) to meet or exceed the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements), and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component reasonably can be expected to remain in use for at least five years.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal roofs with appropriate pigmented coatings which are specifically and primarily designed to reduce the heat loss or gain for a dwelling.

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

Any unused credit may be carried forward to future years.

Effective date.–The credit is effective for qualified energy efficiency improvements installed after December 31, 2003 and before January 1, 2007.

Senate Amendment

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

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

Homes must be certified according to a component-based method or a performance-based method. The component-based method is based on applicable energy-efficiency ratings, including current product labeling requirements. The performance-based method is based on a comparison of the projected energy consumption of the dwelling in its original condition and after the completion of energy efficiency measures. The performance-based method of certification must be conducted by an individual or organization recognized by the Secretary for such purposes.

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

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

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

Effective date.–The credit is effective for qualified energy efficiency improvements installed on or after the date of enactment and before January 1, 2006.

Conference Agreement

The conference agreement generally follows the House bill with the modification that the credit may not be carried forward. Additionally, the efficiency is to be measured relative to the 2000 IECC standards as supplemented and as in effect on the date of enactment.

Effective date.–The credit is effective for qualified energy efficiency improvements installed after December 31, 2003, and before January 1, 2007.

5. Energy efficient new homes (sec. 41005 of the House bill, sec. 2101 of the Senate amendment, and new sec. 45G of the Code)

Present Law

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

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

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

House Bill

The provision provides a credit to an eligible contractor (up to $2,000 per dwelling) of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction.

The eligible contractor is the person who constructs the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property is any energy-efficient building envelope component (insulation materials, exterior windows and doors, metal roofs with appropriate pigmented coatings) and any energy-efficient heating or cooling appliance.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor; (3) certified to have a level of annual heating and cooling energy consumption that is at least 30 percent below the annual level of heating and cooling energy consumption of a comparable dwelling constructed in accordance with the standards of the 2000 International Energy Conservation Code; and (4) with respect to the building envelope alone, certified to have a level of annual heating and cooling energy consumption that is 10 percent below the annual level of heating and cooling energy consumption of a comparable dwelling constructed in accordance with the standards of the 2000 International Energy Conservation Code.

Effective date.–The credit applies to homes whose construction is substantially completed after December 31, 2003, and which are purchased during the period beginning on January 1, 2003, and ending on December 31, 2006.

Senate Amendment

The proposal provides a credit to an eligible contractor of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction. The credit cannot exceed $1,250 ($2,000) in the case of a new home which has a projected level of annual heating and cooling costs that is 30 percent (50 percent) less than a comparable dwelling constructed in accordance with Chapter 4 of the 2000 International Energy Conservation Code.

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

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor; and (3) certified to have a projected level of annual heating and cooling energy consumption that is either 30-percent or 50-percent less than a comparable dwelling constructed in accordance with Chapter 4 of the 2000 International Energy Conservation Code. The home may be certified according to a component-based method or an energy performance based method. Manufactured homes that meet the standards of the Department of Energy's Energy Star program are deemed to satisfy the 30-percent energy efficiency standard.

The component-based method of certification will be based on applicable energy-efficiency specifications or ratings, including current product labeling requirements. The Secretary will develop component-based packages that are equivalent in energy performance to properties that qualify for the credit.

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

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

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

Effective date.–The credit applies to homes whose construction is substantially completed after the date of enactment and which are purchased during the period beginning on the date of enactment and ending on December 31, 2007.

Conference Agreement

The conference agreement generally follows the House bill with modifications. The requirement that the qualified new energy efficient home be used as the principal residence of the person acquiring the home is modified to provide that the contractor reasonably expect such home to be used as a residence of the person who acquires the home from the contractor. The credit amount is limited to $1,000 for new homes that are 30 percent more efficient than the 2000 IECC standards, as supplemented and as in effect on the date of enactment. The credit amount is limited to $2,000 for new homes that are 50 percent more efficient than the 2000 IECC standards, as supplemented and as in effect on the date of enactment. With respect to the building envelope alone, all qualifying new homes must be at least 10 percent more efficient than the 2000 IECC standard as supplemented and as in effect on the date of enactment. Additionally, the conference agreement includes the Senate amendment provision with respect to Energy Star manufactured homes, though the credit is limited to $1,000.

Certification requirements are to be met in accordance with guidance prescribed by the Secretary of the Treasury. Such guidance shall specify procedures and methods for calculating energy and cost savings. It is expected that such guidance will allow for third-party certification, but will also allow the eligible contractor to meet the certification requirements without necessarily involving a third-party certifier. It is also expected that such guidance will provide sufficient safeguards to ensure that only homes meeting the required standards will obtain certification.

The certification shall be made in writing in a manner which specifies the energy efficient building envelope components and energy efficient heating or cooling equipment installed and their respective energy efficiency performance. In the case of homes qualifying under the Energy Star program, the certification shall be accompanied by documentation as required by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program.

The credit is treated as part of the general business credit and, under a special transition rule, may not be carried back to a taxable year ending before or on the effective date of the provision.

Effective date.–The credit applies to homes whose construction is substantially completed after December 31, 2003, and which are purchased during the period beginning on January 1, 2004, and ending on December 31, 2006.

6. Energy credit for combined heat and power system property (sec. 41006 of the House bill, sec. 2108 of the Senate amendment, and sec. 48 of the Code)

Present Law

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

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

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

House Bill

The provision provides a 10-percent credit for the purchase of CHP property.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) that has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities.)

CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

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

Effective date.–The credit applies to property placed in service after December 31, 2003 and before January 1, 2007.

Senate Amendment

The Senate amendment is similar to the House bill. However, for purposes of determining whether CHP property includes technologies which generate electricity or mechanical power using back-pressure steam turbines in place of existing pressure-reducing valves, or which make use of waste heat from industrial processes such as by using organic rankine, stirling, or kalina heat engine systems, the energy output requirements related to heat versus power described under (3), above, and the energy efficiency requirements of (4), above, may be disregarded.

Effective date.–The credit applies to property placed in service after December 31, 2002 and before January 1, 2007.

Conference Agreement

The conference agreement follows the House bill with modifications. The first modification removes the minimum system size requirement and limits the availability of the credit to systems with capacity less than 15 megawatts or 2,000 horsepower. The second modification eliminates the extension of the depreciation period from 15 to 22 years. The third modification is that systems whose fuel source is at least 90 percent bagasse and that would qualify for the credit, but for the failure to meet the efficiency standard, are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

The credit may not be carried back to a taxable year ending before January 1, 2004.

Effective date.–The provision applies to periods after December 31, 2003, in taxable years ending after such date, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990), for property placed in service before January 1, 2007.

7. Energy efficient appliances (sec. 2102 of the Senate amendment and new sec. 45H of the Code)

Present Law

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

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

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

House Bill

No provision.

Senate Amendment

The Senate amendment provides a credit for the production of certain energy-efficient clothes washers and refrigerators. The credit would equal $50 per appliance for energy-efficient clothes washers produced with a modified energy factor ("MEF") of 1.26 or greater and for refrigerators produced that consume 10 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit equals $100 for energy-efficient clothes washers produced with a MEF of 1.42 or greater (1.5 or greater for clothes washers produced after 2004) and for refrigerators produced that consume 15 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

For each category of appliances (i.e., clothes washers that meet the lower MEF standard, washers that meet the higher MEF standard, refrigerators that meet the 10 percent standard, refrigerators that meet the 15 percent standard), only production in excess of average production for each such category during calendar years 1999-2001 would be eligible for the credit. The taxpayer may not claim credits in excess of $30 million for all taxable years for appliances that qualify for the $50 credit, and may not claim credits in excess of $30 million for all taxable years for appliances that qualify for the $100 credit. Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

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

Effective date.–The credit applies to appliances produced after December 31, 2002, and prior to (1) January 1, 2005, in the case of refrigerators that only meet the 10 percent credit standard, or (2) January 1, 2007, in the case of all other qualified energy-efficient appliances.

Conference Agreement

The conference agreement generally follows the Senate amendment with modifications. The $50 credit is eliminated for clothes washers and refrigerators. A credit of $100 is allowed for refrigerators that consume 15 percent (20 percent for refrigerators produced after 2006) less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. A credit of $100 is allowed for clothes washers with a MEF of 1.5 or greater. A credit of $150 is allowed for refrigerators produced prior to 2007 that consume 20 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The $30 million overall credit limitation for each of two separate categories of appliances is replaced with a cap of $60 million across all appliances combined.

The three prior years are the base period years for calculation of the credit for any specific year. To qualify for any credit, production must exceed 110 percent of the average annual production in the base period years. Additionally, in order to determine if production has exceeded the baseline, all clothes washers and refrigerators are treated as a single group, rather than separately by their credit-specific efficiency standard. For example, if in the base period a producer produced an average of 1000 refrigerators and clothes washers combined that would have met the $100 credit standard, and no refrigerators that would have met the $150 credit standard, such producer would need to produce a combination of at least 1100 (110 percent of base period average) refrigerators or clothes washers that met the efficiency standards in order to receive any tax credit. Thus, even thought the base period production of refrigerators meeting the $150 credit standard is zero, a producer would not be eligible to receive a credit for production of such refrigerators unless a combination of at least 1100 refrigerators or clothes washers meeting any of the efficiency standards were produced. The aggregate amount of production eligible for a credit is allocated between the $100 and $150 credit categories in proportion to the total production in each credit category. Only production in the United States is eligible for credit and only U.S. production is considered for the base-period production levels.

The credit is treated as part of the general business credit and, under a special transition rule, may not be carried back to a taxable year ending before or on the effective date of the provision.

Effective date.–The credit applies to appliances produced after December 31, 2003, and before January 1, 2008.

8. Energy efficient commercial building deduction (sec. 2105 of Senate amendment, and new sec. 179B of the Code)

Present Law

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

House Bill

No provision.

Senate Amendment

The Senate amendment provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures are defined as amounts paid or incurred for energy-efficient commercial building property installed in connection with the new construction or reconstruction of property: (1) which is depreciable property, (2) which is located in the United States, and (3) the construction or erection of which is completed by the taxpayer. The deduction is limited to an amount equal to the product of $2.25 and the square footage of the property for which such expenditures were made. The deduction is allowed in the taxable year in which the construction of the building is completed.

Energy-efficient commercial building property means any property that reduces total annual energy and power costs with respect to the lighting, heating, cooling, ventilation, and hot water supply systems of the building by 50 percent or more in comparison to a reference building which meets the requirements of a Standard 90.1-1999 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA").

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, is directed to promulgate regulations that describe methods of calculating and verifying energy and power costs, taking into consideration the provisions of the 2001 California Nonresidential Alternative Calculation Method Approval Manual. To allow proper calculations of cost, the Secretary shall prescribe the costs per unit of energy and power, such as kilowatt hour, kilowatt, gallon of fuel oil, and cubic foot or Btu of natural gas, which may be dependent on time of usage.

The Secretary shall promulgate procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Home Energy Rating Standards. Such procedures are to be fuel neutral, such that the same energy efficiency features shall qualify a building for the deduction under this subsection regardless of whether the heating source is a gas or oil furnace or an electric heat pump. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

When final regulations are adopted, such regulations shall, with respect to methods of calculating and verifying energy and power costs, take into consideration appropriate energy savings from design methodologies and technologies not otherwise credited in ASHRAE/IESNA Standard 90.1-1999 or in the 2001 California Nonresidential Alternative Calculation Method Approval Manual.

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

The basis of the property is reduced by the amount of the deduction allowed.

Effective date.–The Senate amendment is effective for taxable years beginning after September 1, 2002, for plans certified prior to December 31, 2007, whose construction is completed on or before December 31, 2009.

Conference Agreement

The conference agreement follows the Senate amendment with modifications. The maximum deduction is limited to $1.50 per square foot, and energy efficiency is to be measured relative to the Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America, as in effect on April 2, 2003. Additionally, with respect to public property, no transfer of the deduction to the person primarily responsible for designing the property is allowed.

In the case of a retrofitted or reconstructed building, but not a new building placed in service after the date of enactment, that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the lighting system, (2) the heating cooling and ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.50 per square foot for each separate system.

In the case of system-specific partial deductions for retrofitted or reconstructed buildings, in general no deduction is allowed until the Secretary establishes system-specific targets. However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 25 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions.

The conference agreement provides that the Secretary shall establish procedures for certifying eligibility to claim the deduction. The Secretary shall include as part of the certification process procedures for inspection and testing by qualified individuals to ensure compliance of buildings with energy savings plans and targets. Individuals qualifed to determine compliance shall only be those individuals who are recognized by an organization certified by the Secretary for such purposes.

The Secretary, in consultation with the Secretary of Energy, is directed to promulgate regulations that describe methods of calculating and verifying energy and power costs. Additionally, the Secretary is directed to promulgate regulations as necessary to take into account new technologies regarding energy efficiency and renewable energy for purposes of determining energy efficiency and savings. Additionally, the Secretary shall promulgate regulations for recapture of the deduction if the deduction is taken pursuant to a plan to achieve the requisite energy efficiency standard that is subsequently not fully implemented as necessary to achieve such standard.

Effective date.–The provision is effective for property placed in service after the date of enactment and on or before December 31, 2007.

9. Three-year applicable recovery period for depreciation of qualified energy management devices and qualified water submetering devices (secs. 2107 and 2111 of the Senate amendment and sec. 168 of the Code)

Present Law

No special recovery period is currently provided for depreciation of energy management devices or water submetering devices.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a three-year recovery period for qualified new or retrofitted energy management devices placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device is any tangible property eligible for accelerated depreciation under section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

Additionally, the provision provides a three-year recovery period for qualified new water submetering devices placed in service by any taxpayer who is an eligible resupplier. An eligible resupplier is any taxpayer who purchases and installs qualified water submetering devices in every unit in any multi-unit property. A qualified water submetering device is any tangible property eligible for accelerated depreciation under section 168 that enables consumers to manage their purchase or use of water in response to water price and usage signals and that permits reading of water price and usage signals on at least a daily basis.

Effective date.–The provision is effective for any qualified energy management device placed in service after the date of enactment of the Act, and for any water submetering device placed in service after the date of enactment of the Act and prior to January 1, 2008.

Conference Agreement

The conference agreement generally follows the Senate amendment with respect to energy management devices, but with modifications. The conference agreement provides a three-year recovery period for qualified new energy management devices placed in service by any taxpayer who is a supplier of electric energy or is a provider of electric energy services. A qualified energy management device is any meter or metering device eligible for accelerated depreciation under section 168 and which is used by the taxpayer (1) to measure and record electricity usage data on a time-differentiated basis in at least 4 separate time segments per day, and (2) to provide such data on at least a monthly basis to both consumers and the taxpayer.

The conference agreement does not include the Senate amendment provision related to water submetering devices.

Effective date.–The provision is effective for any qualified energy management device placed in service after the date of enactment and prior to January 1, 2008.

10. Allowance of deduction for qualified energy management devices and qualified water submetering devices (secs. 2106 and 2110 of the Senate amendment)

Present Law

No special deduction is currently provided for expenses incurred for energy management devices or water submetering devices.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a $30 deduction for each qualified new or retrofitted energy management device placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device is any tangible property eligible for accelerated depreciation under section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

The deduction is not allowed to property used outside of the United States. The taxpayer would have basis reduction for such property equal to the deduction. Other rules apply.

In addition, the Senate amendment provides a $30 deduction for qualified water submetering devices. A qualified water submetering device is any tangible property eligible for accelerated depreciation under section 168 that enables consumers to manage their purchase or use of water in response to water price and usage signals and that permits reading of water price and usage signals on at least a daily basis.

Effective date.–The provision is effective for any qualified energy management device placed in service after the date of enactment of the Act, and for any water submetering device placed in service after the date of enactment of the Act and prior to January 1, 2008.

Conference Agreement

The conference agreement does not include the Senate amendment.

11. Credit for electricity produced from advanced nuclear power facilities (new sec. 45L of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt-hour for 2003. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement that a taxpayer producing electricity at a qualifying advanced nuclear power facility may claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight year period starting when the facility is placed in service.[4] The aggregate amount of credit that a taxpayer may claim in any year during the eight-year period is subject to limitation based on allocated capacity and an annual limitation as described below.

A qualifying advanced nuclear facility is an advanced nuclear facility for which the taxpayer has received an allocation of megawatt capacity from the Secretary and is placed in service before January 1, 2021. The taxpayer may only claim credit for production of electricity equal to the ratio of the allocated capacity that the taxpayer receives from the Secretary to the rated nameplate capacity of the taxpayer's facility. For example, if the taxpayer receives an allocation of 750 megawatts of capacity from the Secretary and the taxpayer's facility has a rated nameplate capacity of 1,000 megawatts, then the taxpayer may claim three-quarters of the

[4] The 1.8-cents credit amount is reduced, but not below zero, if the annual average contract price per kilowatt-hour of electricity generated from advanced nuclear power facilities in the preceding year exceeds eight cents per kilowatt-hour. The eight-cent price comparison level is indexed for inflation after 1992.

otherwise allowable credit, or 1.35 cents per kilowatt-hour, for each kilowatt-hour of electricity produced at the facility (subject to the annual limitation described below). The Secretary may allocate up to 6,000 megawatts of capacity.

A taxpayer operating a qualified facility may claim no more than $125 million in tax credits per 1,000 megawatts of allocated capacity in any one year of the eight-year credit period. If the taxpayer operates a 1,350 megawatt rated nameplate capacity system and has received an allocation from the Secretary for 1,350 megawatts of capacity eligible for the credit, the taxpayer's annual limitation on credits that may be claimed is equal to 1.35 time $125 million, or $168.75 million. If the taxpayer operates a facility with a nameplate rated capacity of 1,350 megawatts, but has received an allocation from the Secretary for 750 megawatts of credit eligible capacity, then the two limitations apply such that the taxpayer may claim a credit equal to 1.35 cents per kilowatt-hour of electricity produced (as described above) subject to an annual credit limitation of $93.75 million in credits (three-quarters of $125 million).

An advanced nuclear facility is any nuclear facility for the production of electricity, the reactor design for which is approved after the date of enactment. For this purpose, a qualifying advanced nuclear facility is not any facility for which a substantial similar design for a facility of comparable capacity was approved on or before the date of enactment.

In addition, the credit allowable to the taxpayer is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but such reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is treated as part of the general business credit and, under a special transition rule may not be carried back to a taxable year ending before or on the effective date of the provision.

<u>Effective date</u>.–The provision is effective for production in taxable years beginning after December 31, 2003.

B. Fuels and Alternative Motor Vehicles

1. Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels (sec. 41008 of the House bill and secs. 4041, 4042, 6421, and 6427 of the Code)

Present Law

Under present law, diesel fuel used in trains is subject to a 4.4-cents-per gallon excise tax. Revenues from 4.3 cents per gallon of this excise tax are retained in the General Fund of the Treasury. The remaining 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.

Similarly, fuels used in barges operating on the designated inland waterways system are subject to a 4.3-cents-per-gallon General Fund excise tax. This tax is in addition to the 20.1-cents-per-gallon tax rates that are imposed on fuels used in these barges to fund the Inland Waterways Trust Fund and the Leaking Underground Storage Tank Trust Fund.

In both cases, the 4.3-cents-per-gallon excise tax rates are permanent. The LUST tax is scheduled to expire after March 31, 2005.

House Bill

The 4.3-cents-per-gallon General Fund excise tax rate on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system is repealed. The 0.1 cent per gallon for the Leaking Underground Storage Tank ("LUST") Trust Fund is unchanged by the provision.

Effective date.–The provision is effective on January 1, 2004.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

2. Btu-based rate for diesel/water emulsion fuel (sec. 41009 of the House bill and secs. 4081 and 6427 of the Code)

Present Law

A 24.3 cents per gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund. Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund. The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

No special tax rate is provided for diesel fuel blended in a water emulsion fuel.

House Bill

A special tax rate of 19.7 cents per gallon is provided for diesel fuel blended with water into a diesel/water emulsion fuel to reflect the reduced Btu content per gallon resulting from the water. Emulsion fuels eligible for the special rate must consist of not more than 86 percent diesel fuel (and other minor chemical additives to enhance combustion) and at least 14 percent water. Anyone who separates the diesel fuel from the diesel-water fuel emulsion on which a reduced rate of tax was imposed is treated as a refiner of the fuel and is liable for the difference between the amount of tax on the latest removal of the separated fuel and the amount of tax that was imposed on any prior removal or entry of such fuel.

Effective date.–The provision applies to fuels removed after September 30, 2003.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill except as to the effective date.

Effective date.–The provision is effective January 1, 2004.

3. Modifications to small producer ethanol credit (sec. 2005 of the Senate amendment and sec. 40 of the Code)

Present Law

Small producer credit

Present law provides several tax benefits for ethanol and methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit is provided for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The small producer credit is part of the alcohol fuels tax credit under section 40 of the Code. The alcohol fuels tax credits are includible in income. This credit, like tax credits generally, may not be used to offset alternative minimum tax liability. The credit is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit is scheduled to expire after December 31, 2007.

Taxation of cooperatives and their patrons

Under present law, cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Under present law (sec. 38(d)(4)), the only excess credits that may be passed through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)).

House Bill

No provision.

Senate Amendment

The Senate amendment makes several modifications to the rules governing the small producer ethanol credit. First, the provision liberalizes the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the provision allows cooperatives to elect to pass through the small ethanol producer credits to its patrons. The credit is apportioned pro rata among patrons of the cooperative on the basis of the quantity or value of the business done with or for such patrons for the taxable year. An election to pass through the credit is made on a timely filed return for the taxable year and is irrevocable for such taxable year.

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

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

Conference Agreement

The conference agreement generally follows the Senate amendment except the small producer credit will continue to be included in the income of taxpayers claiming it and no exemption from the passive activity rules under the Code is provided. With respect to the alternative minimum tax, the conference agreement provides the same treatment given other business related energy credits that are the subject of the agreement as described below (see sec. 1347 of the Act).

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

4. Transfer full amount of excise tax imposed on gasohol to the highway trust fund (sec. 2006 of the Senate amendment)

Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case of gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 52-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

In general, 18.3 cents per gallon of the gasoline excise tax is deposited in the Highway Trust Fund and 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank Trust Fund (the "LUST" rate). In the case of gasohol with respect to which a reduced excise tax is paid, 2.5 cents per gallon of the reduced tax is retained in the General Fund. The balance of the reduced rate (less the LUST rate) is deposited in the Highway Trust Fund.

House Bill

No provision.

Senate Amendment

The Senate amendment transfers the 2.5 cents per gallon of excise tax on gasohol that currently is retained in the General Fund to the Highway Trust Fund.

Effective date.–The Senate amendment would be effective for taxes imposed after September 30, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Incentives for biodiesel (sec. 2008 of the Senate amendment and new sec. 40A of the Code)

Present Law

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

However, a 52-cents-per-gallon income tax credit (the "alcohol fuels credit") is allowed for ethanol and methanol (derived from renewable sources) when the alcohol is used as a highway motor fuel. The 52-cents-per-gallon rate is scheduled to decline to 51 cents per gallon beginning in calendar year 2005. The benefit of this income tax credit may be claimed through reductions in excise taxes paid on alcohol fuels. In the case of alcohol blended with other fuels (e.g., gasoline), the excise tax rate reductions are allowable only for blends of 90 percent gasoline/10 percent alcohol, 92.3 percent gasoline/7.7 percent alcohol, or 94.3 percent gasoline/5.7 percent alcohol. These present-law provisions are scheduled to expire after 2007.

House Bill

No provision.

Senate Amendment

A new income tax credit is provided for biodiesel fuel mixtures ("biodiesel V" and "biodiesel NV"). The structure of the new credit is similar to structure of the present-law alcohol fuels credit. Biodiesel V is derived from virgin vegetable oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, or mustard seeds, for use in diesel engines. Biodiesel NV is derived from nonvirgin vegetable oils or animal fats for use in diesel engines. Both biodiesel V and biodiesel NV must meet the requirements of the Environmental Protection Agency under section 211 of the Clean Air Act (42 USC 7545) and the American Society of Testing and Materials D6751.

The per gallon biodiesel mixture credit rate for biodiesel V equals one cent for each percentage point of biodiesel in the fuels mixture, subject to a maximum credit of 20 cents per blended gallon of fuel. The per gallon biodiesel mixture credit rate for biodiesel NV equals .5 cent for each percentage point of biodiesel in the fuels mixture, subject to a maximum credit of 20 cents per blended gallon of fuel. The amount of the biodiesel fuel mixture credit is includible in income. The credit cannot be carried back to a taxable year beginning before January 1, 2003.

Mixtures of biodiesel V are subject to a reduced rate of excise tax, which is coordinated with the income tax credit. An excise tax reduction is not available for biodiesel NV.

The provision further provides for transfers to the Highway Trust Fund from the funds of the Commodity Credit Corporation of amounts equivalent to the reduction in receipts to the Trust Fund resulting from the excise tax rate reduction allowed under the provision.

Effective date.–The income tax provision is effective for taxable years beginning after December 31, 2002, for fuel sold before January 1, 2006. The excise tax provision is effective for fuel sold after December 31, 2002, and before January 1, 2006.

Conference Agreement

The conference agreement generally follows S. 1548 as ordered reported by the Committee on Finance on September 17, 2003, with respect to the income tax credit for biodiesel and biodiesel mixtures. The conference agreement does not provide for any reduced excise tax rate for mixtures of biodiesel, including virgin biodiesel.

The provision provides a new income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the excise tax credit for qualified biodiesel mixtures. The credit is treated as part of the general business credit and, under a special transition rule, may not be carried back to a taxable year ending before or on the effective date of the provision. The provision does not apply to fuel used or sold after December 31, 2005.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product. Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act, and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived from virgin oils including esters derived from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

Biodiesel mixture credit

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

Biodiesel credit

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

Later separation or failure to use as fuel

In a manner similar to the treatment of alcohol fuels, a tax is imposed if a biodiesel fuels credit is claimed with respect to biodiesel that is subsequently used for a purpose for which the credit is not allowed or that is changed into a substance that does not qualify for the credit. The first tax applies if two conditions are satisfied. First, a biodiesel mixture credit must have been allowed with respect to biodiesel used in the production of a qualified mixture. Second, any person either separates the biodiesel from the mixture or, without separation, uses the mixture other than as a fuel. The tax equals the applicable amount ($1.00 in the case of agri-biodiesel or 50 cents in the case of other biodiesel) multiplied by the number of gallons of biodiesel in such mixture. The second tax applies if two conditions are satisfied. First, a biodiesel credit must have been allowed with respect to the retail sale of any biodiesel. Second, any person mixes that biodiesel or uses it other than as a fuel. The tax equals the applicable amount multiplied by the number of gallons of biodiesel.

Effective date.–The biodiesel fuel income tax credit provision is effective for fuel produced, and sold or used, after December 31, 2003, in taxable years ending after such date.

6. Alcohol and biodiesel excise tax credit and extension of alcohol fuels income tax credit (secs. 40, 4101, 6427, 9503 and new secs. 4104, and 6426 of the Code)

Present Law

Alcohol fuels income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2007.[5]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[6]) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the blender as fuel, or used as fuel by the blender in producing the mixture. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as

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

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

vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.[7]

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

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

Excise tax reductions for alcohol mixture fuels

Generally, motor fuels tax rates are as follows[8]:

Gasoline	18.4 cents per gallon
Diesel fuel and kerosene	24.4 cents per gallon
Special motor fuels	18.4 cents per gallon generally

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

Gasohol

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

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7 In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 38.52 cents for sales or uses during calendar year 2003 and 2004, and 37.78 cents for calendar years 2005, 2006, and 2007.

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

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2003, the following reduced rates apply to gasohol:[9]

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

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

Qualified methanol and ethanol fuels

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.[11] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2003 and 2004 is 13.15 cents. From January 1, 2005, through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.[12]

Alcohol produced from natural gas

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.[13] For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other

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

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

[11] A 0.05-cent-per-gallon Leaking Underground Storage Tank Trust Fund tax is imposed on such fuel. This provision expires on October 1, 2007 (sec. 4041(b)(2)).

[12] These reduced rates terminate after September 30, 2007.

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

cases, the rate is 11.4 cents per gallon. After September 31, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

A reduced rate of tax applies to diesel fuel or kerosene that is combined with alcohol as long as at least 10 percent of the finished mixture is alcohol. If none of the alcohol in the mixture is ethanol, the rate of tax is 18.4 cents per gallon. For alcohol mixtures containing ethanol, the rate of tax in 2003 and 2004 is 19.2 cents per gallon and for 2005 through September 30, 2007, the rate for ethanol mixtures is 19.3 cents per gallon. Fuel removed or entered for use in producing a 10 percent diesel-alcohol fuel mixture (without ethanol), is subject to a tax of 20.44 cents. The rate of tax for fuel removed or entered to produce a 10 percent diesel-ethanol fuel mixture is 21.333 cents per gallon for 2003 and 2004 and 21.444 cents per gallon for the period January 1, 2005, through September 30, 2007.

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

Aviation fuel

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.[14] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[15] In the case of 10 percent ethanol mixtures, any sale or use during 2003 and 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007.[16]

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

Refunds and payments

If fully taxed gasoline (or other taxable fuel) is used to produce a qualified alcohol mixture, the Code permits the blender to file a claim for a quick excise tax refund. The refund is equal to the difference between the gasoline (or other taxable fuel) excise tax that was paid and the tax that would have been paid by a registered blender on the alcohol fuel mixture being produced. Generally, the IRS pays these quick refunds within 20 days. Interest accrues if the refund is paid more than 20 days after filing. A claim may be filed by any person with respect to

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

[15] Sec. 4041(k)(1) and 4091(c).

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

gasoline, diesel fuel, or kerosene used to produce a qualified alcohol fuel mixture for any period for which $200 or more is payable and which is not less than one week.

Ethyl tertiary butyl ether (ETBE)

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

Highway Trust Fund

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per gallon of the tax imposed is retained in the General Fund.[17] In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.[18]

Biodiesel

If biodiesel is used in the production of blended taxable fuel, the Code imposes tax on the removal or sale of the blended taxable fuel.[19] In addition, the Code imposes tax on any liquid other than gasoline sold for use or used as a fuel in a diesel-powered highway vehicle or diesel-powered train unless tax was previously imposed and not refunded or credited.[20] If biodiesel that was not previously taxed or exempt is sold for use or used as a fuel in a diesel-powered highway

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

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

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

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

vehicle or a diesel-powered train, tax is imposed.[21] There are no reduced excise tax rates for biodiesel.

House bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement creates two new excise tax credits, the alcohol fuel mixture excise tax credit and the biodiesel fuel mixture excise tax credit. The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). The amount of fuel taxes transferred to the Highway Trust Fund is not reduced by any excise tax credits claimed. The conference agreement also extends the alcohol fuels income tax credit (sec. 40) through December 31, 2010.[22]

Alcohol fuel mixture excise tax credit

The conference agreement provides for an excise tax credit, the alcohol fuel mixture credit. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. The credit declines to 51 cents per gallon after calendar year 2004. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon.

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and a taxable fuel that is (1) sold for use or used as a fuel by the taxpayer producing the mixture or (2) removed from the refinery by a person producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas,

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

[22] The conference agreement contains several provisions found in S. 1548 as ordered reported by the Committee on Finance on September 17, 2003. While similar to S. 1548, the conference agreement differs from S. 1548 in several respects. Unlike S. 1548, the conference agreement leaves in place the present-law reduced rate excise tax structure. Also, the conference agreement does not eliminate the requirement that 2.5 and 2.8 cents per gallon of the reduced rate of excise tax be retained in the General Fund. In addition, the conference agreement does not contain any provisions regarding payments with respect to qualified alcohol and biodiesel fuel mixtures nor with respect to alcohol and biodiesel used as a fuel.

or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Taxable fuel is gasoline, diesel, and kerosene.[23]

The excise tax credit is coordinated with the alcohol fuels income tax credit and is available through December 31, 2010. In addition, any excise tax exemption for alcohol fuels reduces the amount of the alcohol fuel excise tax credit.[24]

Biodiesel mixture excise tax credit

The provision provides an excise tax credit for biodiesel mixtures.[25] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and taxable fuel that is (1) sold for use or used by the taxpayer producing such mixture as a fuel, or (2) removed from the refinery by a person producing the mixture. In the case of agri-biodiesel, the amount of the credit is $1.00 per gallon. The credit applies only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel which identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

The credit is not available for any sale, use or removal for any period after December 31, 2005. This excise tax credit is coordinated with the income tax credit for biodiesel such that the credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Later separation or mixture not used as fuel

Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit or biodiesel fuel mixture credit is claimed with respect to alcohol or biodiesel used in the production of any alcohol or biodiesel mixture, that is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The tax applies if two conditions are satisfied. First, a credit must have been allowed with respect to alcohol or biodiesel used in the production of a qualified mixture. Second, any person either separates the alcohol or biodiesel from the mixture or, without separation, uses the mixture other than as a fuel. The tax equals the applicable amount multiplied by the number of gallons of such alcohol or biodiesel.

Registration requirements

Under the provision, the Secretary shall require registration of every person that produces biodiesel or alcohol.

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

[24] Rules similar to those found in section 40(c) regarding the income tax credit for alcohol fuels apply.

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

Information reporting for persons claiming certain tax benefits

The Secretary shall require any person claiming tax benefits under certain sections relating to alcohol and biodiesel fuels[26] to file a quarterly return (in such manner as the Secretary may prescribe) providing such information relating to such benefits and the coordination of such benefits as the Secretary may require to ensure the proper administration and use of such benefits. With respect to persons required to register with the Secretary, failure to comply with these information-reporting requirements could subject such a person to the denial, revocation or suspension of registration.

Refund claims

If fully taxed gasoline (or other taxable fuel) is used to produce a qualified alcohol mixture, the Code permits the blender to file a claim for a quick excise tax refund. For claims filed after December 31, 2004, if such claims are not paid within 45 days, the claim is to be paid with interest. In the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest. If claims are filed electronically, the claimant may make a claim for less than $200. The Secretary is to prescribe the electronic format for filing claims not later than December 31, 2004.

Highway Trust Fund

The provision provides that the amount of fuel taxes to be appropriated to the Highway Trust Fund shall be determined without reduction for amounts equivalent to the excise tax credits allowed for alcohol fuel mixtures and biodiesel mixtures.

Effective date.–In general, the provisions are effective for fuel sold, used, or removed after December 31, 2003. The provisions relating to refund claims are effective for claims filed after December 31, 2004.

7. Nonapplication of export exemption to delivery of fuel to motor vehicles removed from United States (sec. 2504 of the Senate amendment and secs. 4221, 4041, and 4081 of the Code)

Present Law

A manufacturer's excise tax is imposed upon

(1) The removal of any taxable fuel from a refinery or terminal;

(2) The entry of any taxable fuel into the United States for consumption, use or warehousing; or

[26] These sections are sections 34, 40, 40A, 4041(b)(2), 4041(k), 4081(c), 6426, and 6427(f).

(3) The sale of any taxable fuel to any person who is not registered, unless there was a prior taxable removal or entry.[27]

The term "taxable fuel" means gasoline, diesel fuel and kerosene.

Special provisions under the Code provide for a refund of tax to any person who sells gasoline to another for exportation.[28] Section 6421(c) provides "If gasoline is sold to any person for any purpose described in paragraph (2), (3), (4), or (5) of section 4221(a), the Secretary shall pay (without interest) to such person an amount equal to the product of the number of gallons so sold multiplied by the rate at which tax was imposed on such gasoline by section 4081." Section 4221 provides, in pertinent part, "Under regulations prescribed by the Secretary, no tax shall be imposed under this chapter. . . on the sale by the manufacturer . . of an article--. . . for export, or for resale by the purchaser to a second purchaser for export . . . but only if such exportation or use is to occur before any other use . . ."

It is the IRS administrative position that the exemption from manufacturers excise tax by reason of exportation does not apply to the sale of motor fuel pumped into a fuel tank of a vehicle that is to be driven, or shipped, directly out of the United States.[29]

A duty-free sales facility that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales facility on which neither Federal duty nor Federal tax has been assessed pending exportation from the customs territory of the United States. The statutes covering duty-free facilities do not contain any limitation on what goods may qualify for duty-free treatment.

The United States Court of Federal Claims ("Claims Court") and a District Court in Michigan have taken different positions on whether fuel sold from a duty-free facility and placed into the tank of an automobile that is then driven out of the country is exported fuel.[30] Both cases involved the same duty-free facility, which is near the Canadian border and is configured

[27] Sec. 4081(a)(1).

[28] Secs. 6421(c) and 4221(a)(2).

[29] Rev. Rul. 69-150.

[30] See, *Ammex Inc. v. United States*, 52 Fed. Cl. 303 (2002) (on cross-motions for summary judgment, the court found that plaintiff established standing to proceed to trial pursuant to sec. 6421(c) respecting its gasoline purchases only); and *Ammex Inc. v. United States*, 2002 U.S. Dist. LEXIS 25771 (E.D. Mich. July 31, 2002) (granting defendant's motion for summary judgment), reconsideration denied, *Ammex, Inc. v. United States*, 2002 U.S. Dist. LEXIS 22893 (E.D. Mich. Oct. 22, 2002). Although the Claims Court ruled that Ammex had standing to challenge the excise tax on gasoline, it subsequently held that Ammex was not entitled to a payment pursuant to sec. 6421(c) because it failed to prove at trial that it did not pass the tax on to its customers. *Ammex Inc. v. United States*, 2003 U.S. Claims LEXIS 63 (Fed. Cl. Mar. 26, 2003).

in such a way that anyone leaving the facility must depart the United States and enter into Canada. The District Court agreed with the IRS position that such fuel is not exported, while the Claims Court reached the opposite conclusion. The Claims Court concluded that the act of exportation began with the consumer's purchase and that the fuel necessarily enters into the stream of exportation at the moment it is placed into the fuel supply tank and the customer drives into Canada.

House Bill

No provision.

Senate Amendment

The Senate amendment amends section 555(b) of the Tariff Act of 1930 (19 U.S.C. 1555(b)) to provide that gasoline or diesel fuel sold at duty-free facilities are considered to be entered for consumption into the United States and thus ineligible for classification as duty-free merchandise.

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

Conference Agreement

The conference agreement reaffirms the long-standing IRS position taken in Rev. Rul. 69-150 and restates present law by amending the Code definition of export to exclude the delivery of a taxable fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States. It also imposes a tax on the sale of taxable fuel at a duty-free sales enterprise unless there was a prior taxable removal, or entry of such fuel.

Effective date.–The provision applies to sales or deliveries made after the date of enactment.

8. Modification of credit for electric vehicles (sec. 41010 of the House bill, sec. 2002 of Senate amendment, and sec. 30 of the Code)

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006. There is no carry forward or carryback of the credit for electric vehicles.

House Bill

The House bill repeals the phased-down reduction in the credit for years 2004, 2005, and 2006. Thus, the House bill provides that a taxpayer may claim the full 10-percent credit (up to a $4,000) maximum for the purchase of qualified electric vehicles before January 1, 2007.

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

Senate Amendment

The Senate amendment modifies the present-law credit for electric vehicles to provide that the credit for qualifying vehicles generally ranges between $3,500 and $40,000 depending upon the weight of the vehicle and, for certain vehicles, the driving range of the vehicle. In the case of property purchased by tax-exempt persons, the seller may claim the credit. The taxpayer would be ineligible for the deduction allowable under present-law section 179A for a qualified battery electric vehicle on which a credit is allowable. The provision also extends the expiration date of the credit from December 31, 2004, to December 31, 2006, and would repeal the phase-out schedule of present law. The taxpayer would be able to carry forward unused credits for 20 years or carry unused credits back for three years (but not carried back to taxable years beginning before the October 1, 2002).

Effective date.–The Senate amendment is effective for property placed in service after September 30, 2002.

Conference Agreement

The conference agreement follows the House bill.

9. Alternative motor vehicle credit (sec. 41011 of the House bill, secs. 2001 and 2010 of Senate amendment, and new sec. 30B of the Code)

Present Law

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether).[31] The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

[31] A hybrid-electric vehicle may qualify as a clean-fuel vehicle under present law.

House Bill

Clean-fuel vehicles

The House bill repeals the phased-down reduction in the allowable deduction for years 2004, 2005, and 2006. Thus, the provision provides that a taxpayer could claim a full deduction for allowable costs of clean-fuel vehicles purchased before January 1, 2007.

Fuel cell vehicles

The House bill provides a credit for the purchase of a new qualified fuel cell motor vehicle. A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. In general the House bill provides that the buyer claims the credit, unless the buyer is a tax-exempt entity in which case the seller or lessor of the vehicle may claim the credit. The provision permits unused credits to be carried forward for up to 20 years. Qualified fuel cell motor vehicles are vehicles placed in service before 2013.

The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2000 model year city fuel economy rating for vehicles of various weight classes (see below). Table 1, below, shows the base credit amounts.

Table 1.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
vehicle = 8,500..	$4,000
8,500 < vehicle = 14,000..................................	$10,000
14,000 < vehicle = 26,000................................	$20,000
26,000 < vehicle...	$40,000

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

Table 2.–Credit for Qualifying Fuel Cell Vehicles

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

Advanced lean-burn technology motor vehicle

The House bill provides a credit for the purchase of a new advanced lean burn technology motor vehicle. A qualifying advanced lean burn technology motor vehicle must meet the Environmental Protection Agency's Tier II bin 8 emissions standards. In general the provision provides that the buyer claims the credit, unless the buyer is a tax-exempt entity in which case the seller or lessor of the vehicle may claim the credit. The House bill permits unused credits to be carried forward for up to 20 years. Qualified advanced lean burn technology motor vehicles are vehicles placed in service before 2007. Table 3, below, shows the credits for the purchase of an advanced lean burn technology motor vehicle.

Table 3.–Credit for Qualifying Advanced Lean Burn Technology Motor Vehicles

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

In addition to the credit amount shown in Table 3, an advanced lean burn technology automobile or light truck may be eligible for an additional credit of $250 if the vehicle achieves an estimated lifetime fuel savings of at least 1,500 gallons of fuel and a further additional credit of $500 if the vehicle achieves an estimated lifetime fuel savings of at least 2,500 gallons compared to a like conventional vehicle (using the 2000 model year city fuel economy rating for the like vehicle and assuming 120,000 miles driven).

Base fuel economy

The base fuel economy is the 2000 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act.

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

Senate Amendment

Section 179A

The Senate amendment extends the present-law deduction through December 31, 2011, for hydrogen-related property and through December 31, 2007, for all other vehicles. The Senate amendment provides that the otherwise allowable deduction is reduced by 25 percent in 2004 through 2009 for hydrogen-related property and in 2004 and 2005 for all other vehicles. The Senate amendment reduces the otherwise allowable deduction by 50 percent and 75 percent in 2010 and 2011 respectively in the case of hydrogen-related property and in 2006 and 2007 for all other vehicles.

Fuel cell motor vehicles

The Senate amendment provides a credit for the purchase of qualified fuel cell motor vehicles. The base credit for the purchase of new qualified fuel cell motor vehicles ranges between $4,000 and $40,000 depending upon the weight class of the vehicle. For automobiles and light trucks, the otherwise allowable credit amount ($4,000) is increased by an amount from $1,000 to $4,000 if the vehicle meets certain fuel economy increases compared to a stated standard. Credit may not be claimed for qualified fuel cell motor vehicles purchased after December 31, 2011.

Hybrid motor vehicles

The Senate amendment provides a credit for the purchase of qualified hybrid motor vehicles. The base credit for the purchase of a new qualified hybrid motor vehicle ranges from $250 to $10,000 depending upon the weight of the vehicle and the maximum power available from the vehicle's rechargeable energy storage system. For automobiles and light trucks, the otherwise allowable credit amount ($250 to $1,000) is increased by an amount from $500 to $3,000 if the vehicle meets certain fuel economy increases. For heavy duty hybrid motor vehicles, the otherwise allowable credit ($1,000 to $10,000) is increased depending upon the vehicle's weight and provided the vehicle meets certain 2007 (and beyond) emissions standards. The amount of credit is increased by between $3,500 and $14,000 for vehicles placed in service in 2002; is increased by between $3,000 and $12,000 for vehicles placed in service in 2003, is increased by between $2,500 and $10,000 for vehicles placed in service in 2004, is increased by between $2,000 and $8,000 for vehicles placed in service in 2005, and is increased by between $1,500 and $6,000 for vehicles placed in service in 2006. Credit may not be claimed for qualified hybrid motor vehicles purchased after December 31, 2006.

Alternative fuel motor vehicles

The Senate amendment provides a credit for the purchase of qualified alternative fuel motor vehicles. The base credit for the purchase of a new alternative fuel motor vehicle equals 40 percent of the incremental cost of such vehicle. The otherwise allowable credit for 40 percent of the incremental cost is increased by an additional 30 percent of the incremental cost of the vehicle if the vehicle meets certain emissions standards. For computation of the credit, the incremental cost of the vehicle may not exceed between $5,000 and $40,000 (resulting in a maximum total credit of between $3,500 and $28,000) depending upon the weight of the vehicle. For this purpose, incremental cost generally is defined as the amount of the increase of the manufacturer's suggested retail price of such a vehicle compared to the manufacturer's suggested retail price of a comparable gasoline or diesel model. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel (except in the extent gasoline or diesel fuel is part of a qualified mixed fuel). Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid mixture consisting of at least 85 percent methanol.

Taxpayers purchasing certain mixed-fuel vehicles also may claim the alternative fuel motor vehicle credit, at a reduced rate. A mixed-fuel vehicle is a vehicle with gross weight of seven tons or more and is certified by the manufacturer as being able to operate on a combination of alternative fuel and a petroleum-based fuel. A qualifying mixed-fuel vehicle must use at least 75 percent alternative fuel (a "75/25 mixed-fuel vehicle") or 90 percent alternative fuel (a "90/10 mixed-fuel vehicle") and be incapable of operating on a mixture containing less than 75 percent alternative fuel in the case of a 75/25 vehicle (less than 90 percent alternative fuel in the case of a 90/10 vehicle). A taxpayer purchasing a 75/25 mixed-fuel vehicle may claim 70 percent of the otherwise allowable credit. A taxpayer purchasing a 90/10 mixed-fuel vehicle may claim 90 percent of the otherwise allowable credit.

Credit may not be claimed for qualified alternative fuel motor vehicles purchased after December 31, 2006. The taxpayer's basis in the property is reduced by the amount of credit claimed.

Provisions of general application

The Senate amendment provides that unused credits may be carried forward for 20 years and three years (but not into taxable years beginning before October 1, 2002).

If a tax-exempt person purchases or leases a qualifying vehicle, the seller or lessor may claim the credit.

Effective date

The Senate amendment is effective for property placed in service after September 30, 2002.

Conference Agreement

Clean-fuel vehicles (Section 179A)

The conference agreement follows the House bill with respect to modifications to present-law section 179A.

Fuel cell vehicles

The conference agreement follows the House bill with respect to providing a credit for the purchase of a new qualified fuel cell motor vehicle, except the base-year for fuel economy comparisons is modified as described below.

Hybrid motor vehicles

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualifying hybrid motor vehicle must be placed in service before January 1, 2009.

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard and a conservation credit based on the estimated lifetime fuel savings of a qualifying vehicle compared to a comparable 2002 model year vehicle. A qualifying hybrid automobile or light truck must have a maximum available power from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain EPA emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 4, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy.

Table 4.–Fuel Economy Credit

	If Fuel Economy of the Hybrid Vehicle Is:	
Credit	**at least**	**but less than**
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy

Credit	If Fuel Economy of the Hybrid Vehicle Is: at least	but less than
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 5, below, shows the conservation credit.

Table 5.–Conservation Credit

Estimated Lifetime Fuel Savings	Conservation Amount
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 2,400	$500
At least 2,400 but less than 3,000	$750
At least 3,000	$1,000

In the case of a qualifying hybrid motor vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualifying hybrid motor vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is $7,500. For a qualifying hybrid motor vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is $15,000. For a qualifying hybrid motor vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is $30,000.

A qualifying hybrid motor vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualifying hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.

The conferees recognize that these heavier hybrid vehicles generally are trucks and vans. The fuel economy performance of trucks and vans varies by the use of such equipment. For example, used by a plumbing company generally carry more weight than an otherwise identical van used by a florist. Hence, the fuel economy performance of the plumbing vans should be worse than that of the floral vans. In basing the credit for these heavier hybrid vehicles on fuel economy, the conferees do not intend that any fuel economy standards for such heavier vehicles be promogulated. Rather, the conferees intend that the Secretary provide guidance so that fuel economy increases may be assessed on a case-by-case basis accounting for the intended use of the vehicles.

Advanced lean-burn technology motor vehicles

The conference agreement a credit for the purchase of a new advanced lean burn technology motor vehicle. The amount of credit for the purchase of an advanced lean burn technology motor vehicle is the sum of two components: a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard as described in Table 4, above and a conservation credit based on the estimated lifetime fuel savings of a qualifying vehicle compared to a comparable 2002 model year vehicle as described in Table 5 above.

A qualifying advanced lean burn technology motor vehicle that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. A qualifying advanced lean burn technology motor vehicle must be placed in service before January 1, 2009.

Limitation on number of qualified hybrid and advanced lean-burn technology motor vehicles eligible for the credit

The conference agreement imposes a limitation on the number of qualified hybrid motor vehicles and advanced lean-burn technology motor vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter in which the manufacturer records its sale of the 80,000th hybrid and advanced lean-burn technology motor vehicle. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the quarter after the manufacturer has recorded its 80,000th such sale. In the third and fourth calendar quarters subsequent to the quarter after the manufacturer has recorded its 80,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, summing the sales of qualifying hybrid motor vehicles of all weight classes and all sales of qualifying advanced lean-burn technology motor vehicles, if a manufacturer records the sale of its 80,000th in February of 2006, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualifying vehicles through June 20, 2006. For the period July 1, 2006, through December 31, 2006, taxpayers may claim one half of the otherwise allowable credit on purchases of qualifying vehicles of the manufacturer. For the period January 1, 2007, through June 30, 2007, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualifying vehicles of the manufacturer. After June 30, 2007, no credit may be claimed for purchases of hybrid motor vehicles or advanced lean-burn technology motor vehicles sold by the manufacturer.

Alternative fuel motor vehicles

The credit for the purchase of a new alternative fuel vehicle is 40 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between $5,000 and $40,000 depending upon the weight of the vehicle. Table 6, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class.

Table 6.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating in Pounds	Maximum Allowable Incremental Cost
vehicle = 8,500..	$5,000
8,500 < vehicle = 14,000..................................	$10,000
14,000 < vehicle = 26,000................................	$25,000
26,000 < vehicle..	$40,000

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

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

A qualifying alternative fuel vehicle (or mixed fuel vehicle) must be placed in service before January 1, 2007.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act.

Alternative minimum tax and credit carry forward or carry back

Taxpayers may claim credits with respect to purchases of qualified vehicles against both their regular and alternative minimum tax liabilities.

The conference agreement provides that credits allowable, but unused in the current year, from the purchase of a qualifying vehicle for business use may be carried back one year and forward 20 years.[32] Credit allowable with respect to a vehicle purchased for personal use may only be claimed in the year of purchase. The Secretary shall issue regulations under which qualified vehicle sold at retail is display a notice stating that the vehicle is a qualified vehicle and that the buyer may not benefit from the credit allowed if the buyer has insufficient tax liability to be offset by the allowable credit.

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

10. Modifications of deduction for refueling property (secs. 2003 and 2010 of Senate amendment and sec. 179A of the Code)

Present Law

Certain costs of qualified clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. Natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether comprise clean-burning fuels.

The deduction is unavailable for property placed in service after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the present-law deduction to property placed in service before January 1, 2008, and to property placed in service before January 1, 2012, in the case of hydrogen refueling property.

In addition, the Senate amendment provision permits taxpayers to claim a 50-percent credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property the allowable credit may not exceed $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed

[32] The credit, however, is not made part of the general business credit.

$1,000. The taxpayer's basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed.

In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2007 (before January 1, 2012 in the hydrogen refueling property). The credit allowable in the taxable year cannot exceed the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. The taxpayer may carry forward unused credits for 20 years.

Effective date.–The Senate amendment is effective for property placed in service after September 30, 2002.

Conference Agreement

The conference agreement extends and modifies present-law section 179A with respect to refueling property. The conference agreement increases the present-law limitation of $100,000 of qualifying expenses per refueling location of the taxpayer to $150,000 per location. In addition, the conference agreement modifies the definition of refueling property with respect to hydrogen produced from another clean-burning fuel (*i.e.*, natural gas, liquefied natural gas, liquefied petroleum gas, any fuel at least 85 percent of which is one or more of methanol, ethanol, or other alcohol or ether) such that qualified refueling property included property for the production of hydrogen fuel, in addition to property for the storage and dispensing of hydrogen fuel, if such property is located at the point where hydrogen fuel is delivered into the fuel tank of a motor vehicle.

The conference agreement extends the placed in service date for qualifying refueling property to property placed in service prior to January 1, 2009 (January 1, 2012, in the case of property related to hydrogen fuel).

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

11. Credit for retail sale of alternative motor vehicle fuels (secs. 2004 and 2010 of Senate amendment)

Present Law

There is no retail credit for the sale of alternative motor vehicle fuels. However, a 52-cents-per-gallon income tax credit is allowed for alcohol fuels for 2003 and 2004 (51 cents for 2005-2007). The alcohol fuels credit may be claimed as a reduction in excise tax payments. Such tax payments generally are made before the retail level. In the case of ethanol, the Code provides a separate 10-cents-per-gallon credit for small producers.

House Bill

No provision.

Senate Amendment

The Senate amendment permits taxpayers to claim a credit equal to the gasoline gallon equivalent of 30 cents per gallon of alternative fuel sold 2002 and in 2003, 40 cents per gallon in 2004, and 50 cents per gallon thereafter. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, any liquid mixture consisting of at least 85 percent methanol, and any liquid mixture consisting of at least 85 percent ethanol. The credit may be claimed for sales prior to January 1, 2007. Under the provision, the credit is part of the general business credit.

Effective date.–The Senate amendment is effective for fuel sold at retail after September 30, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

II. RELIABILITY

A. Natural Gas Gathering Lines Treated as Seven-Year Property (sec. 42001 of the House bill, sec. 2302 of the Senate amendment, and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[33] Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. The 10th Circuit Court of Appeals and the 6th Circuit Court of Appeals have held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., seven-year recovery period).[34] The Tax Court has held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 46.0 (*i.e.*, 15-year recovery period).[35]

House Bill

The House bill establishes a statutory 7-year recovery period and a class life of 10 years for natural gas gathering lines. In addition, the House bill provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property. A natural gas gathering line is defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

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

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[33] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[34] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 T.C. 416 (1997). *Saginaw Bay Pipeline Co. v. United States*, 2003 FED App. 0259P (6th Cir.) *rev'g* 124 F. Supp. 2d 465 (E.D. Mich. 2001). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

[35] *Clajon Gas Co., L.P. v. Commissioner*, 119 T.C. 197 (2002).

Senate Amendment

The Senate amendment is the same as the House bill, except that it does not include the provision providing that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to natural gas gathering lines.

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

Conference Agreement

The conference agreement follows the House bill with the following modification. The conference agreement provides a class life of 14 years for natural gas gathering lines (instead of 10 years).

B. Natural Gas Distribution Lines Treated as Fifteen-Year Property (sec. 42002 of the House bill, sec. 2311 of the Senate amendment, and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[36] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

House Bill

The House bill establishes a statutory 15-year recovery period and a class life of 20 years for natural gas distribution lines. In addition, the House bill provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

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

Senate Amendment

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

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

Conference Agreement

The conference agreement follows the House bill with the following modification. The conference agreement provides a class life of 35 years for natural gas distribution lines (instead of 20 years).

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[36] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

C. Transmission Property Treated as Fifteen-Year Property (sec. 42003 of the House bill and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56. Assets used in the transmission and distribution of electricity for sale and related land improvements are assigned a 20-year recovery period and a class life of 30 years.

House Bill

The House bill establishes a statutory 15-year recovery period and a class life of 20 years for certain assets used in the transmission of electricity for sale and related land improvements. For purposes of the provision, section 1245 property used in the transmission of electricity for sale at 69 kilovolts and above will qualify for the new recovery period. In addition, the House bill provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with the following modifications. The conference agreement limits the provision to property the original use[37] of which commences

[37] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, if on August 11, 2004, a taxpayer buys from RCM for $200,000 transmission lines that have been previously used by RCM. Subsequent to the purchase, the taxpayer makes an expenditure on the property of $50,000 of the type that must be capitalized. Regardless of whether the $50,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original use" requirement and would be eligible for the reduced recovery period. No part of the $200,000 purchase price qualifies for the reduced recovery period.

after the date of enactment and alters the class life of such property to 30 years (instead of 20 years).

D. Expensing of Capital Costs Incurred for Production in Complying with Environmental Protection Agency Sulfur Regulations for Small Refiners (sec. 42004 of the House bill, sec. 2303 of the Senate amendment, and new sec. 179C of the Code)

Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions.

House Bill

The bill permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA").

For these purposes a small business refiner is a taxpayer who is within the business of refining petroleum products employs not more than 1,500 employees directly in refining and has less than 205,000 barrels per day (average) of total refinery capacity. The deduction is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

Effective date.–The provision is effective for expenses paid or incurred after March 31, 2003.

Senate Amendment

The Senate amendment generally is the same as the House bill.

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

Conference Agreement

The conference agreement generally follows the House bill and the Senate amendment except with respect to the effective date. The conference agreement also clarifies that qualifying expenditures are those expenditures paid or incurred with respect to a facility beginning January 1, 2003, and ending the earlier of the date that is one year after the date on which the taxpayer must comply with applicable EPA regulation or December 31, 2009. In addition, with respect to the definition of a small business refiner, the conferees intend that, in any case in which refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, capacity be measured by reference to the average daily output of refined product.

Effective date.–The provision is effective for expenses paid or incurred after December 31, 2002.

E. Credit for Small Refiners for Production of Diesel Fuel in Compliance with Environmental Protection Agency Sulfur Regulations for Small Refiners (sec. 42005 of the House bill, sec. 2304 of Senate amendment, and new sec. 45I of the Code)

Present Law

Present law does not provide a credit for the production of low-sulfur diesel fuel.

House Bill

The House bill provides that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The taxpayer's basis in such property is reduced by the amount of production credit claimed.

For these purposes a small business refiner is a taxpayer who is within the business of refining petroleum products employs not more than 1,500 employees directly in refining and has less than 205,000 barrels per day (average) of total refinery capacity. The credit is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

Effective date.–The provision is effective for expenses paid or incurred after March 31, 2003.

Senate Amendment

The Senate amendment generally is the same as the House. In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization.

Effective date.–The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. The conference agreement provides that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The taxpayer's basis in such property is reduced by the amount of production credit claimed. In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization.

In addition, with respect to the definition of a small business refiner, the conferees intend that, in any case where refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, capacity be measured by reference to the average daily output of refined product.

The conference agreement also clarifies that qualifying expenditures are those expenditures paid or incurred with respect to a facility beginning January 1, 2003 and ending the earlier of the date that is one year after the date on which the taxpayer must comply with applicable EPA regulation or December 31, 2009.

Effective date.–The provision is effective for expenses paid or incurred after December 31, 2002.

F. Determination of Small Refiner Exception to Oil Depletion Deduction (sec. 42006 of the House bill, sec. 2305 of the Senate amendment, and sec. 613A of the Code)

Present Law

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

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

House Bill

The provision increases the current 50,000-barrel-per-day limitation to 75,000. In addition, the provision changes the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery run for the taxable year may not exceed 75,000 barrels. For this purpose, the taxpayer calculates average daily production by dividing total production for the taxable year by the total number of days in the taxable year.

<u>Effective date</u>.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment is similar to the House Bill except the average daily refinery run may not exceed 60,000 barrels.

<u>Effective date</u>.–The Senate amendment is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement follows the House bill, except the average daily refinery run for the taxable year may not exceed 67,500 barrels.

<u>Effective date</u>.–The provision is effective for taxable years ending after the date of enactment.

G. Sales or Dispositions to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy (sec. 42007 of the House bill, sec. 2404 of the Senate amendment, and sec. 451 of the Code)

Present Law

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

House Bill

The House bill permits a taxpayer to elect to recognize gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[38] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain shall be recognized to the extent of such excess in the year of the qualifying electric transmission transaction. Any remaining realized gain is recognized ratably over the eight-year period.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider[39] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

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[38] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[39] For example, a regional transmission organization, an independent system operator, or and independent transmission company.

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the provision permits the reinvestment property to be purchased by any member of the affiliated group (in lieu of the taxpayer).

If a taxpayer elects the application of the House bill, then the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain eligible for the provision is realized, attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary of the Treasury is notified by the taxpayer of the reinvestment property or an intention not to reinvest.

An electing taxpayer is required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in the manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years.[40] In addition, an electing taxpayer is required to attach a statement that identifies the reinvestment property in the manner as the Secretary shall prescribe.

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

Senate Amendment

Similar to the House bill, but does not have a reinvestment obligation.

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

Conference Agreement

The conference agreement follows the House bill.

[40] The provision also provides that the installment sale rules shall not apply to any qualifying electric transmission transaction for which a taxpayer elects the application of this provision.

H. Modification to Special Rules for Nuclear Decommissioning Costs (sec. 42008 of the House bill, sec. 2402 of the Senate amendment, and sec. 468A of the Code)

Present Law

Overview

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

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[41]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service requirement").[42] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

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

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

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

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

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[43] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[44]

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[45] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

House Bill

Repeal of cost of service requirement

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

Permit contributions to a qualified fund for pre-1984 decommissioning costs

The House bill also repeals the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant's decommissioning costs incurred during the period that the qualified fund is in existence (generally post-1984 decommissioning costs). Thus, any taxpayer is permitted to accumulate an amount sufficient to cover the present value of 100 percent of a nuclear powerplant's estimated decommissioning costs in a qualified fund. The

[43] Treas. reg. sec. 1.468A-6.

[44] Treas. reg. sec. 1.468A-6(f).

[45] These funds are generally referred to as "nonqualified funds."

House bill does not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

Exception to ruling amount for certain decommissioning costs

The House bill permits a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of the amount required to fund a nuclear powerplant's decommissioning costs which under present law section 468A(d)(2)(A) is not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).[46] It is anticipated that an amount that is permitted to be contributed under this special rule shall be determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule that has not previously been deducted or excluded from gross income is allowed as a deduction over the remaining useful life of the nuclear powerplant.[47] If a qualified fund that has received amounts under this rule is transferred to another person, the transferor will be permitted a deduction for any remaining deductible amounts at the time of transfer.

Contributions to a qualified fund after useful life of powerplant

The House bill also allows deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments are permitted to the extent they do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Clarify treatment of transfers of qualified funds

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

Effective date.–The provision would be effective for taxable years beginning after December 31, 2003.

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

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

Senate Amendment

Repeal of cost of service requirement

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

Clarify treatment of transfers of qualified funds and deductibility of decommissioning costs

The Senate amendment clarifies the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee (or the qualified fund) as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established. In addition, the Senate amendment provides that all nuclear decommissioning costs are deductible when paid or incurred.

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

Conference Agreement

The conference agreement follows the House bill with the following modifications. The conference agreement clarifies that, for purposes of the exception to ruling amount for certain costs (generally pre-1984 decommissioning costs), only the present value of total nuclear decommissioning costs with respect to a nuclear powerplant previously excluded under section 468A(d)(2)(A) may be contributed to a qualified fund. For example, if $100 is the present value of the total decommissioning costs of a nuclear powerplant, and if under present law the qualified fund is only permitted to accumulate (and has in fact accumulated) $75 of decommissioning costs over such plant's estimated useful life (because the qualified fund was not in existence during 25 percent of the estimated useful life of the nuclear powerplant), a taxpayer could contribute $25 to the qualified fund under this component of the provision.

In addition, the Conference agreement provides that a purchaser of an interest in a nuclear powerplant may elect to treat certain amounts previously set aside for nuclear decommissioning by the seller and transferred to the taxpayer as part of the sale as if such amounts had been contributed to a qualified fund immediately prior to the transfer.[48] The adjusted basis of such assets shall be the same as in the hands of the seller. The election is available only if the seller of the interest in the nuclear powerplant is a tax-exempt entity. In addition, the maximum amount eligible for such treatment is limited to the product of the present value of the estimated nuclear decommissioning costs and the applicable percentage. The "applicable percentage" is a fraction equal to the number of years the powerplant has been in service over the estimated useful life of such powerplant. A taxpayer shall make the election in the manner prescribed by the Secretary by the due date (including extensions of time) for its

[48] An election under this special rule shall be disregarded in determining the Federal income tax treatment of the sale to the seller.

return of tax for the year in which the acquisition occurs. In addition, a taxpayer must request a new ruling amount from the IRS to be eligible for this provision.

I. Treatment of Certain Income of Electric Cooperatives (sec. 42009 of the House bill, secs. 2403 and 2406 of the Senate amendment, and sec. 501 of the Code)

Present Law

In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The Internal Revenue Service requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).[49]

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

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

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

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net

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[49] Announcement 96-24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996-16 *I.R.B.* 35.

income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative (sec. 521).

Taxation of electric cooperatives exempt from subchapter T

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (sec. 1381(a)(2)(C)). Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative. [50]

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).[51] The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the Federal Government.

The receipt by a rural electric cooperative of contributions in aid of construction and connection charges is taken into account for purposes of applying the 85-percent test.

Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under section 511.

Credit for producing fuel from a nonconventional source

Under present law, an income tax credit is allowed for certain fuels produced from "non-conventional sources" and sold to unrelated parties. The amount of the credit is equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29), subject to a phaseout. Qualified fuels must be produced within the United States, and include: oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams,

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[50] *See* Rev. Rul. 83-135, 1983-2 C.B. 149.

[51] Rev. Rul. 72-36, 1972-1 C.B. 151.

tight formations ("tight sands"), or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

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

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

House Bill

Treatment of income from open access transactions

The House bill provides that income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an independent transmission provider agreement approved by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities)[52] is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

For purposes of the 85-percent test, the House bill also provides that income received or accrued by a rural electric cooperative is treated as an amount collected from members for the sole purpose of meeting losses and expenses if the income is received or accrued indirectly from a member of the cooperative, provided that such income is derived from a "like organization" activity of the cooperative under present law.[53]

Treatment of income from nuclear decommissioning transactions

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

(1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit;

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[52] Under this provision, references to FERC are treated as including references to the Public Utility Commission of Texas.

[53] *See, e.g.*, Rev. Rul. 2002-54, 2002-37 I.R.B. 527; Rev. Rul. 83-170, 1983-2 C.B. 97; Rev. Rul. 65-201, 1965-2 C.B. 170.

(2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or

(3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

Treatment of income from asset exchange or conversion transactions

The House bill provides that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or methane-based natural gas.

Treatment of income from load loss transactions

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

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

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

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

Effective date

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

Senate Amendment

Treatment of income from open access transactions

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

(1) the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis: (i) pursuant to an open access transmission tariff filed with and approved by the Federal Energy Regulatory Commission ("FERC") (including acceptable reciprocity tariffs), but only if (in the case of a voluntarily filed tariff) the cooperative files a report with FERC within 90 days of enactment of this provision relating to whether or not the cooperative will join a regional transmission organization ("RTO"); or (ii) under an RTO agreement approved by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities); [54]

(2) the provision or sale of electric energy distribution services or ancillary services on a nondiscriminatory open access basis to end-users served by distribution facilities owned by the cooperative or its members; or

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

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

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

Treatment of income from nuclear decommissioning transactions

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

(1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit;

(2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or

(3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

Treatment of income from asset exchange or conversion transactions

The Senate amendment provides that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or natural gas.

Treatment of cancellation of indebtedness income from prepayment of certain loans

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

Treatment of income from load loss transactions

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

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

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

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

Treatment of income from certain contributions in aid of construction

The Senate amendment excludes from the 85-percent test for tax exemption under section 501(c)(12) the receipt by an electric cooperative, before January 1, 2007, of any contribution in aid of construction or connection charge (in the form of money, property, capital or otherwise) that is intended to facilitate the provision of electric service by the cooperative for the purpose of the development, by the recipient of such electric service, of qualified fuels from nonconventional sources (within the meaning of section 29, as modified elsewhere in the Senate amendment).

Effective date

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

Conference Agreement

The conference agreement follows the House bill with the following modifications:

Treatment of income from open access transactions

Income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by FERC or under an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities)[55] is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

In addition, income is excluded for purposes of the 85-percent test if it is received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy distribution services or ancillary services, provided such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the cooperative: (1) to end-users who are served by distribution facilities not owned by the cooperative or any of its members; or (2) generated by a generation facility that is not owned or leased by the cooperative or any of its members and that is directly connected to distribution facilities owned by the cooperative or any of its members.

Treatment of income from load loss transactions

For purposes of this provision, the "start-up year" is defined as the first year that the cooperative offers nondiscriminatory open access or, if later and at the election of the cooperative, the calendar year that includes the date of enactment of this provision.

Effective date

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

1. Exempt certain prepayments for natural gas from tax-exempt bond arbitrage rules (sec. 3213 of the House bill and secs. 141 and 148 of the Code)

Present Law

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax (sec. 103). Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the "arbitrage restrictions"). One such restriction limits the use of bond proceeds to acquire "investment-type property." The term investment-type property includes the acquisition of property in a transaction involving a prepayment. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

On August 4, 2003, the Treasury Department issued final regulations deeming to be customary, and not in violation of the arbitrage rules, certain prepayments for natural gas and

[55] Under this provision, references to FERC are treated as including references to the Public Utility Commission of Texas.

electricity. Generally, a qualified prepayment under the regulations requires that 90 percent of the natural gas or electricity purchased with the prepayment be used for a qualifying use. Generally, natural gas is used for a qualifying use if it is to be (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, however, gas used to produce electricity for sale is not included under this provision (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric service area customers of the issuing utility, (3) used by the issuing municipal utility to produce electricity that will be sold to a utility owned by a governmental person and furnished to the service area retail electric customers of the purchaser, (4) sold to a utility that is owned by a governmental person if the requirements of (1), (2) or (3) are satisfied by the purchasing utility (treating the purchaser as the issuing utility) or (5) used to fuel the pipeline transportation of the prepaid gas supply. Electricity is used for a qualifying use if it is to be (1) furnished to retail service area electric customers of the issuing municipal utility or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser. Both governmental gas and electric utilities may take advantage of this regulatory provision.

House Bill

In general

The provision creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. The term "investment type property" does not include a prepayment under a qualified natural gas supply contract. The provision also provides that such prepayments are not treated as private loans for purposes of the private business tests.

Under the provision, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility is not treated as the acquisition of investment-type property. A contract is a qualified natural gas contract if the volume of natural gas secured for any year covered by the prepayment does not exceed the sum of (1) the average annual natural gas purchased (other than for resale) by customers of the utility within the service area of the utility ("retail natural gas consumption") during the testing period, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. The testing period is the 5-calendar-year period immediately preceding the calendar year in which the bonds are issued. A retail customer is one who does not purchase natural gas for resale. Natural gas used to generate electricity by a governmental utility is counted as retail natural gas consumption if the electricity was sold to retail customers within the service area of the governmental electric utility.

Adjustments

The volume of gas permitted by the general rule is reduced by natural gas otherwise available on the date of issuance. Specifically, the amount of natural gas permitted to be acquired under a qualified natural gas contract for any period is to be reduced by natural gas held by the utility on the date of issuance of the bonds and natural gas that the utility has a right to acquire for the prepayment period (determined as of the date of issuance).[56] For purposes of the preceding sentence, applicable share means, with respect to any period, the natural gas allocable to such period if the gas were allocated ratably over the period to which the prepayment relates.

For purposes of the safe harbor, if after the close of the testing period and before the issue date of the bonds (1) the government utility enters into a contract to supply natural gas (other than for resale) for a commercial person for use at a property within the service area of such utility and (2) the gas consumption for such property was not included in the testing period or the ratable amount of natural gas to be supplied under the contract is significantly greater than the ratable amount of gas supplied to such property during the testing period, then the amount of gas permitted to be purchased may be increased to accommodate the contract.

The average annual retail natural gas consumption calculation for purposes of the safe harbor, however, is not to exceed the annual amount of natural gas reasonably expected to be purchased (other than for resale) by persons who are located within the service area of such utility and who, as of the date of issuance of the issue, are customers of such utility.

Intentional acts

The safe harbor does not apply if the utility engages in intentional acts to render (1) the volume of natural gas covered by the prepayment to be in excess of that needed for retail natural gas consumption, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility.

Definition of service area

Service area is defined as (1) any area throughout which the governmental utility provided (at all times during the testing period) in the case of a natural gas utility, natural gas transmission or distribution service, or in the case of an electric utility, electric distribution service; (2) limited areas contiguous to such areas, and (3) any area recognized as the service area of the governmental utility under State or Federal law. Contiguous areas are limited to any area within a county contiguous to the area described in (1) in which retail customers of the utility are located if such area is not also served by another utility providing the same service.

Ruling request for higher prepayment amounts

Upon written request, the Secretary may allow an issuer to prepay for an amount of gas greater than that allowed by the safe harbor based on objective evidence of growth in gas consumption or population that demonstrates that the amount permitted by the exception is insufficient.

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[56] For example, natural gas otherwise available on the date the bonds are issued includes supply covered by other prepayment contracts for the period, and supply held in storage or subject to an option to purchase by such utility that is available for retail natural gas consumption during the period covered by the prepayment. It does not include supply that could be purchased on the open market during the prepayment period.

Effective date

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

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with a conforming amendment. The conferees understand that a qualified natural gas supply contract as defined in the conference agreement is not nongovernmental output property for purposes of subsection (d) of section 141. The conference agreement provides that subsection (d) of section 141 does not apply to prepayment contracts for natural gas or electricity that either under the Treasury regulations or statutory safe harbor are not investment-type property for purposes of the arbitrage rules under section 148. No inference is intended regarding the application of subsection 141(d) to prepayment contracts not covered by the statutory safe harbor or Treasury regulations.

The conferees also recognize that a number of States have created under State law joint action agencies that can serve as purchasing agents for their member municipal gas utilities. The conferees intend the provision to allow municipal utilities in a State to participate in such buying arrangements as established under State law, subject to the same limitations that would apply if an individual utility were to purchase gas directly. When acting on behalf of its municipal gas utility members, the total amount of gas that can be purchased by a joint action agency under the bill's exception to the arbitrage rules is the aggregate of what each such member could purchase for itself on a direct basis. Thus, with respect to qualified natural gas supply contracts entered into by joint action agencies for or on behalf of one or more member municipal utilities, the requirements of the safe harbor are tested at the individual municipal utility level based on the amount of gas that would be allocated to such member during any year covered by the contract.

III. PRODUCTION

A. Oil and Gas Provisions

1. Oil and gas production from marginal wells (sec. 43001 of the House bill, sec. 2301 of the Senate amendment, and secs., 38, 39, and new sec. 45J of the Code)

Present Law

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

House Bill

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

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

The credit is treated as part of the general business credit; however, unused credits can be carried back for up to 10 years rather than the generally applicable carryback period of one year.

Effective date.–The provision is effective for production in taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment is the similar to the House bill, except it does not permit the credit to be carried back beyond the date of enactment and a marginal well that is not in compliance with the applicable State and Federal pollution prevention, control, and permit requirements for any period of time is not considered a qualified marginal well during such period.

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

Conference Agreement

The conference agreement generally follows the House bill except unused credits may be carried back only five years.

Effective date.–The provision is effective for production in taxable years beginning after December 31, 2003.

2. Temporary suspension of limitation based on 65 percent of taxable income and extension of suspension of taxable income limit with respect to marginal production (sec. 43002 of the House bill, sec. 2306 of the Senate amendment, and sec. 613A of the Code)

Present Law

In general

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

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[57] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

Two methods of depletion are currently allowable under the Internal Revenue Code (the "Code"): (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

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

Percentage depletion and related income limitations

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[58] Generally, under the percentage depletion method 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). The 100-percent net-income limitation for marginal wells is suspended for taxable years beginning after December 31, 1997, and before January 1, 2004.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and certain trust distributions) (sec. 613A(d)(1)).[59] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

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

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

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

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,[60] are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

[58] Sec. 613A.

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

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

House Bill

The limit on percentage depletion deductions to no more than 65 percent of the taxpayer's overall taxable income is suspended for taxable years beginning after December 31, 2003, and before January 1, 2007. The suspension of the 100-percent net-income limitation for marginal wells is extended an additional three years, through taxable years beginning before January 1, 2007.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment suspends only the 100-percent net-income limitation for marginal wells through 2007.

Effective date.–The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement suspends the 100-percent net-income limitation for marginal wells through December 31, 2004. The conference agreement suspends the 65-percent-taxable-income limitation through December 31, 2004.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

3. Delay rental payments (sec. 43003 of the House bill, sec. 2308 of the Senate amendment, and sec. 167 of the Code)

Present Law

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

House Bill

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

Effective date.–The House bill provision is effective for amounts paid or incurred in taxable years after 2003. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

Senate Amendment

The Senate amendment provides delay rental payments incurred in connection with the development of oil or gas must be amortized over two years.

Effective date.–The Senate amendment is effective for amounts paid or incurred in taxable years after 2002.

Conference Agreement

The conferees adopt a provision nearly identical to a provision in S. 1149 as reported by the Senate Committee on Finance on May 23, 2003. The provision allows delay rental payments incurred in connection with the development of oil or gas within the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

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

4. Geological and geophysical costs (sec. 43004 of the House bill, sec. 2307 of the Senate amendment, and sec. 167 of the Code)

Present Law

Under present law, geological and geophysical expenditures are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. Capital expenditures are not currently deductible as ordinary and necessary expenses, but are allocated to the cost of the property (sec. 263). Courts have held that geological and geophysical costs are capital, and therefore, are allocable to the cost of property acquired or retained. The costs attributable to such exploration are allocable to the cost of the property acquired or retained.

House Bill

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

Effective date.–The House bill provision is effective for costs paid or incurred in taxable years after 2003. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date geological and geophysical costs.

Senate Amendment

The Senate Amendment provides that geological and geophysical costs incurred in connection with domestic oil and gas exploration to be amortized over two years.

Effective date.–The Senate amendment is effective for costs paid or incurred in taxable years after 2002.

Conference Agreement

The conferees adopt a provision nearly identical to a provision in S. 1149 as reported by the Senate Committee on Finance on May 23, 2003. The provision allows geological and geophysical amounts incurred in connection with oil and gas exploration in the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

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

B. Extension and Modification of Credit for Producing Fuel From a Non-Conventional Source (sec. 43005 of the House bill, secs. 2309 and 2310 of the Senate amendment, and sec. 29 and new section 45K of the Code)

Present Law

An income tax credit is allowed for certain fuels produced from "non-conventional sources" and sold to unrelated parties. The amount of the credit is equal to $3 (generally adjusted for inflation[61]) per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States, and include: oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

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

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

House Bill

The House bill permits taxpayers to claim the section 29 credit for production of certain non-conventional fuels produced at wells placed in service after April 1, 2003, and before January 1, 2007. Qualifying fuels are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams or a tight formation. The value of the credit is re-based to $3.00 for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. The credit may be claimed for production from the well for each of the first four years of production, but not for any production occurring after December 31, 2009.

The House bill further permits production from certain existing wells (any well drilled after December 31, 1979, and before January 1, 1993) to claim a credit equal to the newly re-indexed value of $3.00 for production in 2003 after date of enactment through 2006.

The House bill also permits landfill gas sold to a third party from facilities placed in service after June 30, 1998 and before January 1, 2007, to be eligible for five years of credit from the later of the date of enactment or the date the facility is placed in service. The amount of credit is $3.00 per barrel equivalent in 2003 and is indexed for inflation commencing with the credit amount for 2004. In the case of a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines, the amount of credit

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[61] The value of the section 29 credit for production in 2002 was $6.35 per barrel of oil equivalent.

is $2.00 per barrel equivalent in 2003 and is indexed for inflation commencing with the credit amount for 2004.

Under the House bill, the taxpayer may not claim any credit for production in excess of a daily average[62] of 200,000 cubic feet of gas, or barrel of oil equivalent (200,000 cubic feet is equivalent to 35.4 barrels of oil) from a qualifying well or facility with respect to any production for which credit can be claimed under the modifications described.

The House bill adds section 29 to the list of general business credits.

Effective date.–The House bill provision is effective for fuel sold from qualifying wells and facilities after April 1, 2003.

Senate Amendment

Extension for certain non-conventional fuels

The Senate amendment provides a credit for production of certain non-conventional fuels produced at wells placed in service after the date of enactment and before January 1, 2005. The amount of the credit is $3.00 (unindexed) per barrel or Btu oil equivalent for three years of production commencing when the facility is placed in service. Qualified fuels are oil from, shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams or a tight formation.

Extension and modification for "refined coal"

The Senate amendment provides a credit for production of "refined coal" from facilities placed in service after the date of enactment and before January 1, 2007. The amount of the credit is $3.00 (unindexed) per barrel or Btu oil equivalent for five years of production commencing when the facility is placed in service. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less SO_2 and nitrogen oxides than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2002, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. However, no fuel produced at a qualifying advanced clean coal facility (as defined elsewhere) is a qualifying fuel.

Expansion for "viscous oil"

The Senate amendment provides a credit for production of certain viscous oil produced at wells placed in service after the date of enactment and before January 1, 2005. "Viscous oil" is domestic crude oil produced from any property if the crude oil has a weighted average gravity of 22 degrees API or less (corrected to 60 degrees Fahrenheit). The amount of the credit for viscous oil is $3.00 per barrel or Btu equivalent for three years of production commencing when

[62] The daily average is computed as total production divided by the total number of days the well or facility was in production during the year.

the well is placed in service. The Senate amendment provides that qualifying sales to related parties for consumption not in the immediate vicinity of the wellhead qualify for the credit.

<u>Credit for coalmine methane gas</u>

The Senate amendment provides a credit for production of "coalmine methane gas" captured or extracted from a coal mine and sold after the date of enactment and before January 1, 2005. The amount of the credit is $3.00 (unindexed) per barrel or Btu oil equivalent (51.7 cents per million Btu of heat value in the gas) for gas utilized captured or sold, for three years of production commencing when the facility is placed in service. Qualifying coalmine methane gas is any methane gas liberated during qualified mining operations or extracted up to five years in advance of qualified mining operations as part of a specific plan to mine a coal deposit. In the case of coalmine methane gas that is captured in advance of qualified coal mining operations, the credit is allowed only after the date the coal extraction occurs in the immediate area where the coalmine methane gas was removed.

<u>Expansion for agricultural and animal wastes</u>

The Senate amendment adds facilities producing liquid, gaseous, or solid fuels, from agricultural and animal waste placed in service after the date of enactment and before January 1, 2005, to the list of qualified facilities for purposes of the non-conventional fuel credit. The amount of the credit is equal to $3.00 (unindexed) per barrel or Btu oil barrel equivalent, for three years of production commencing on the date the facility is placed in service. Agricultural and animal waste includes by-products, packaging, and any materials associated with processing, feeding, selling, transporting, or disposal of agricultural or animal products or wastes, including wood shavings, straw, rice hulls, and other bedding for the disposition of manure.

<u>Extension of credit for certain existing facilities</u>

The Senate amendment extends the present-law credit through December 31, 2004, for production from existing facilities producing coke, coke gas, or natural gas and by-products produced by coal gasification from lignite.

<u>Study of coal bed methane gas</u>

The Senate amendment provides that the Secretary of Treasury undertake a study of the effect of section 29 on the production of coal bed methane. The Secretary's study is to be made in conjunction with the study to be undertaken by the Secretary of the Interior on the effects of coal bed methane production on surface and water resources, as provided in section 607 of the Energy Policy Act of 2002 (should that study be required by law). The study should estimate the total amount of credit claimed annually and in aggregate related to the production of coal bed methane since the enactment of section 29. The study should report the annual value of the credit allowable for coal bed methane compared to the average annual wellhead price of natural gas (per thousand cubic feet of natural gas). The study should estimate the incremental increase in production of coal bed methane that has resulted from the enactment of section 29. The study should also estimate the cost to the Federal government, in terms of the net tax benefits claimed, per thousand cubic feet of incremental coal bed methane produced annually and in aggregate since the enactment of section 29.

Effective date

The Senate amendment is effective for fuel sold after the date of enactment.

Conference Agreement

In general

The conferees follow the House bill structure and a related provision in S. 1149 as reported by the Senate Committee on Finance on May 23, 2003. In general, the provision permits taxpayers to claim the section 29 credit for certain new wells or facilities placed in service after date of enactment and before January 1, 2007, and the provision also permits taxpayers to claim the section 29 credit for certain existing wells and facilities. For all qualifying wells and facilities the value of the credit is $3.00 for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. The credit can be claimed for production for each of the first four years of production, but not for any production occurring after December 31, 2009. The amount of the credit a taxpayer may claim with respect to any well or facility is subject to the daily limit.

Extension of placed in service date for certain new facilities

For new facilities producing qualifying fuels that are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams or a tight formation, the credit can be claimed for production from such new facilities placed in service after date of enactment and before January 1, 2007. Credit may be claimed for production for each of the first four years of production, but not for any production occurring after December 31, 2009.

Extension of credit for existing oil and gas wells or facilities

The provision permits production from certain existing wells (any well drilled after December 31, 1979, and before January 1, 1993) to claim a credit equal to the newly re-indexed value of $3.00 for production in 2003 after the date of enactment through 2007.

Extension of credit for certain other existing wells or facilities

The provision extends the present-law credit through 2007, for production from existing facilities producing natural gas and by-products produced by coal gasification from lignite.

Extension for landfill gas facilities

The provision permits landfill gas sold from facilities placed in service after June 30, 1998, and before January 1, 2007, to be eligible for four years of credit from the later of January 1, 2004, or the date such facility is placed in service and ending on the earlier of the date that is four years after the date such period began or December 31, 2009. In the case of a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines the amount of credit is $2.00 per barrel equivalent in 2003 and is indexed for inflation commencing with the credit amount for 2004.

Expansion for coke facilities

The provision permits a facility for producing coke or coke gas which was placed in service before January 1, 1993, or after June 30, 1998, or after the date of enactment and before January 1, 2007, to claim a credit beginning on the later of January 1, 2004, or the date such facility is placed in service and ending the earlier of the date four years after such period began or December 31, 2009. A facility currently claiming the credit under section 29(g) may not claim any credit at the $3.00 rate in the future.

Expansion for fuels from agricultural and animal waste

The provision adds facilities producing liquid, gaseous, or solid fuels, from agricultural and animal waste placed in service after the date of enactment and before January 1, 2007, to the list of qualified facilities for purposes of the non-conventional fuel credit. Taxpayers may claim the credit beginning on the later of January 1, 2004, or the date such facility is placed in service and ending the earlier of the date which is four years after such date began or December 31, 2009. Agricultural and animal waste includes by-products, packaging, and any materials associated with processing, feeding, selling, transporting, or disposal of agricultural or animal products or wastes. An example of transforming agricultural and animal waste into qualifying fuels is through the use of the thermal depolymerization process.

Expansion for "refined coal"

The provision also expands section 29 to include certain "refined coal" as a qualified non-conventional fuel. "Refined coal" is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) from facilities placed in service after date of enactment and before January 1, 2008. Taxpayers may claim the credit for fuel produced during the five-year period beginning on the date the facility is placed in service and without being subject to the general rule disallowing credit for production and sale after December 31, 2009. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxide and either sulfur dioxide or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. A facility qualifies if the taxpayer certifies (in such a manner as the Secretary may prescribe) that the refined coal meets these requirements. Refined coal also includes a qualifying fuel derived from high-carbon fly ash. However, no fuel produced at a qualifying advanced clean coal facility (as defined elsewhere) would be a qualifying fuel.

The conferees intend that fuels made from coal using the Fischer-Tropsch process would qualify as refined fuel provided that such fuels satisfy the environmental and value tests described above. The Fischer-Tropsch process for producing diesel fuel can be separated into three main parts: (1) the production of synthesis gas from the main feedstock; (2) the catalytic reaction which converts the synthesis gas into hydrocarbon components; and (3) the refining of these hydrocarbon components into diesel fuel. Production of synthesis gas is accomplished by reforming the feedstock through partial oxidation reforming, autotherman reforming,[63] or steam reforming.

Expansion for coalmine gas

In addition, the provision permits taxpayers to claim credit for coalmine gas captured or extracted by the taxpayer during the period beginning on the day after the date of enactment and ending on December 31, 2006, and utilized as a fuel source or sold by or on behalf of the taxpayer to an unrelated person. The term "coalmine gas" means any methane gas which is being liberated during qualified coal mining operations or as a result of past qualified coal mining operations, or which is captured 10 years in advance of qualified coal mining operations as part of specific plan to mine a coal deposit. In the case of coalmine gas that is captured in advance of qualified coal mining operations, the credit is allowed only after the date the coal extraction occurs in the immediate area where the coalmine gas was removed. The capture or extraction of coalmine gas from coal mining operations is required to be in compliance with applicable Federal pollution prevention, control, and permit requirements in order to qualify for the credit.

Daily limit

Under the provision, a taxpayer would not be able to claim any credit for production in excess of a daily average[64] of 200,000 cubic feet of natural gas or barrel of oil equivalent (200,000 cubic feet is equivalent to approximately 35.4 barrels of oil) of such gas with respect to any property or facility for which credit can be claimed under the modifications above.[65] All facilities eligible for the $3.00 credit under the conference agreement are subject to this limitation.

New phaseout adjustment

In the case of fuels sold after 2003, the dollar amount is $3.00 (without regard to a phaseout adjustment). The new phaseout is increased to $35.00.

General business credit

The provision adds section 29 to the list of general business credits and re-labels present section 29 of the Code as new Code section 45K.

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[63] Autotherman reforming can be accomplished with the use of ambient air, enriched air, or pure oxygen.

[64] The daily average is computed as total production divided by the total number of days the well or facility was in production during the year. Days before the date the project is placed in service are not taken into account in determining the daily average.

[65] The conferees observe that the daily limit adopted in the conference agreement is identical to the provision in H.R. 6 as passed by the House of Representatives and in S. 1149 as reported by the Senate Committee on Finance.

Effective date

The provision is effective for fuel produced and sold from qualifying wells and facilities after December 31, 2003. For application of the general business credit, the provision is effective for taxable years ending after December 31, 2003.

C. Alternative Minimum Tax Provisions

1. Allow personal energy credits against the alternative minimum tax (sec. 41007 of the House bill, secs. 2103(b) and 2109(b) of the Senate amendment, and sec. 26 of the Code)

Present Law

With certain exceptions, for taxable years beginning after December 31, 2003, nonrefundable personal credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

House Bill

The House bill allows the personal energy credits added by the bill to offset both the regular tax and the alternative minimum tax. (The credits added by the House bill include the credit for residential solar energy property, the credit for qualified fuel cell power plants, and the credit for energy efficient improvements to existing homes)

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Senate Amendment

The Senate amendment is the same as the House bill. (The credits added by the Senate amendment include the credit for residential energy efficient property and the credit for energy efficient improvements to existing homes.)

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment and allows the personal energy credits added by the conference agreement (credits for residential energy efficient property and energy efficiency improvements to existing homes) to offset both the regular tax and the alternative minimum tax.

Effective date.–The provision is effective for taxable years beginning after December 31, 2003.

2. Increase tax limitation on use of business energy credits (secs. 43006 and 43008 of the House bill, secs. 2005(b)(3) and 2503(c) of the Senate amendment, and sec. 38 of the Code)

Present Law

Generally, business tax credits may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability). Credits in excess of the limitation may be carried back one year and carried over for up to 20 years.

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

House Bill

The House bill treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to (1) the business energy credits added by the bill for construction of new energy efficient homes; for production of low sulfur diesel fuel; and for oil and gas production from marginal wells, (2) for taxable years beginning in 2004 and 2005, the enhanced oil recovery credit, and (3) the section 45 credit for electricity produced from a wind facility (placed in service after the date of enactment) during the first four years of production beginning on the date the facility is placed in service.

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

Senate Amendment

The Senate amendment allows the small ethanol producer credit and the Alaska natural gas credit to be claimed against the entire regular tax and alternative minimum tax; other business energy credits are subject to the present law limitation.

Effective date.–The provision is effective with effective date of the respective credits.

Conference Agreement

The conference agreement treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to (1) the business energy credits added by the bill for construction of new energy efficient homes, energy efficient appliances, production of low sulfur diesel fuel, and oil and gas production from marginal wells; (2) for taxable years beginning after December 31, 2003, the section 40 alcohol fuels credit; (3) for taxable years beginning in 2004 and 2005, the section 43 enhanced oil recovery credit; and (4) the section 45 credit for electricity produced from a facility (placed in service after the date of enactment) during the first four years of production beginning on the date the facility is placed in service.

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

3. Intangible drilling costs (IDCs) (sec. 43007 of the House bill and sec. 57 of the Code)

Present Law

Taxpayers who pay or incur intangible drilling or development costs ("IDCs") in the development of domestic oil or gas production may elect to either expense or capitalize these amounts. If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred.

The difference between the amount of a taxpayer's IDC deduction and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period is an item of tax preference for the alternative minimum tax ("AMT") to the extent that this amount exceeds 65 percent of the taxpayer's net income from oil and gas properties for the taxable year. This preference applies to taxpayers other than integrated oil companies only to the extent that the failure to apply the preference would result in a reduction of the taxpayer's alternative minimum taxable income by more than 40 percent.

House Bill

The bill repeals the AMT preference for intangible drilling costs for oil and gas wells for taxpayers other than integrated oil companies.

Effective date.–The provision applies to taxable years beginning after December 31, 2003, and beginning before January 1, 2006.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

D. Clean Coal Incentives

1. Credit for production from a clean coal technology unit (secs. 2201 and 2221 of Senate amendment)

Present Law

Present law does not provide a production credit for electricity generated at units that use coal as a fuel. However, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste units placed in service prior to January 1, 2002 (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5-cent figure is indexed for inflation and equals 1.8 cents for 2002. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The production tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

The Senate amendment provides a production credit for electricity produced from certain units that have been retrofitted, repowered, or replaced with a clean coal technology within ten years of the date of enactment. The value of the credit is 0.34 cents per kilowatt-hour of electricity produced and is indexed for inflation occurring after 2002 with the first potential adjustment in 2004.

A qualifying clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. To be a qualified clean coal technology unit, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to units only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. However, no qualifying unit would be eligible if the unit's capacity exceeded 300 megawatts.

Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) are eligible to obtain certifications from the Secretary for these credits and sell, trade, or assign the credit to any taxpayer. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent trades are not permitted.

Effective date.–The Senate amendment is effective for electricity sold after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Investment credit for clean coal technology units (secs. 2211 and 2221 of Senate amendment and new sec. 48A of the Code)

Present Law

Present law does not provide an investment credit for electricity generating units that use coal as a fuel. However, a nonrefundable, 10-percent investment tax credit ("business energy credit") is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). The business energy tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

In general

The Senate amendment provides a 10-percent investment tax credit for qualified investments in advanced clean coal technology units. Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) will be eligible to obtain certifications from the Secretary of the Treasury (as described below) for these credits and sell, trade, or assign the credit to any taxpayer. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent trades are not permitted.

Qualifying advanced clean coal technology units

Qualifying advanced clean coal technology units must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology, pressurized fluidized bed combustion technology, integrated gasification combined cycle technology, or some other technology certified by the Secretary of Energy. Any qualifying advanced clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying advanced clean coal technology unit must meet certain carbon emissions requirements.

If the advanced clean coal technology unit is an advanced pulverized coal or atmospheric fluidized bed combustion technology unit, a pressurized fluidized bed combustion technology unit, or an integrated gasification combined cycle technology unit and if the unit uses a design coal with a heat content of not more than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.60 pound of carbon per kilowatt hour of electricity produced. If the advanced clean coal technology unit is an advanced pulverized coal or atmospheric fluidized bed combustion technology unit, a pressurized fluidized bed combustion technology unit, or an integrated gasification combined cycle technology unit and if the unit uses a design coal with a heat content greater than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.54 pound of carbon per kilowatt hour of electricity produced. In the case of an advanced clean coal technology unit that uses another eligible technology and if the unit uses a design coal with a heat content of not more than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.51 pound of carbon per kilowatt hour of electricity produced. In the case of an advanced clean coal technology unit that uses another eligible technology and if the unit uses a design coal with a heat content greater than 9,000 Btu per pound, the unit must have a carbon emission rate less than 0.459 pound of carbon per kilowatt hour of electricity produced.

Allocation of credits

To be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 4,000 megawatts of capacity, not more than 1,000 megawatts in total and not more than 500 megawatts in years prior to 2009 shall be allocated to units using advanced pulverized coal or atmospheric fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 500 megawatts in total and not more than 250 megawatts in years prior to 2009 shall be allocated to units using pressurized fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 2,000 megawatts in total and not more than 1,000 megawatts in years prior to 2009 and not more than 1,500 megawatts in year prior to 2013 shall be allocated to units using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 4,000 megawatts of capacity, not more than 500 in total and not more than 250 megawatts in years prior to 2009 shall be allocated to any other technology certified by the Secretary of Energy.

Effective date

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

Conference Agreement

In general

The conference establishes an investment tax credit for qualified clean coal property. The credit amount is 15 percent for property placed in service in connection with any basic clean coal technology unit and 17.5 percent for property placed in service in connection with any advanced clean coal technology unit. Qualifying clean coal property is section 1245 property installed in connection with an existing coal-based unit for the production of electricity as part of a conversion to a basic or advanced clean coal technology unit, or is installed in connection with a new advanced clean coal technology unit. Qualifying property must be placed in service after December 31, 2003, and if part of a basic clean coal technology unit before January 1, 2014. If the qualifying property is placed in service as part of an advanced clean coal technology unit, it must be placed in service prior to January 1, 2017.

The total amount of clean coal property eligible for the credit is subject to a national megawatt limitation (detailed below). To be eligible to claim the credit, the taxpayer must receive an allocation of megawatt capacity from the Secretary. The amount of credit the taxpayer may claim with respect to clean coal property is the otherwise allowable credit amount multiplied by the ratio of the national megawatt capacity limitation allocated to the taxpayer over the total nameplate capacity of the taxpayer's unit.

In addition, the credit allowable to the taxpayer is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but such reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is treated as part of the general business credit and, under a special transition rule may not be carried back to a taxable year ending before or on the effective date of the provision.

Basic clean coal technology units

A qualifying clean coal technology unit is a unit using clean coal technology (including advanced pulverized coal or atmospheric fluidized bed combustion, pressurized fluidized bed combustion, and integrated gasification combined cycle) for the production of electricity. The unit must use at least 75 percent coal to produce at least 50 percent of its thermal output as electricity. In addition, the unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying clean coal technology unit cannot be a unit that is receiving or is scheduled to receive funding under the Clean Coal Technology Program, the Power Plant Improvement Initiative, or the Clean Coal Power Initiative administered by the Secretary of the Department of Energy. Lastly, to be a qualified clean coal technology unit, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to units only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. However, no qualifying unit is eligible if the unit's rated nameplate capacity prior to January 1, 2004, exceeded 300 megawatts. The maximum eligible allocation to any qualifying unit may not exceed 300 megawatts.

Advanced clean coal technology units

A qualifying advanced clean coal technology unit is a unit using: (1) advanced pulverized coal or atmospheric fluidized bed combustion technology (2) qualifying pressurized fluidized bed combustion technology; (3) integrated gasification combined cycle technology; or (4) other qualifying technology.

(1) A qualifying advanced pulverized coal or atmospheric fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2013 and having a design net heat rate of not more than 8,500 Btu (8,900 Btu if the unit is placed in service before 2009).

(2) A qualifying pressurized fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,500 Btu if the unit is placed in service after 2008 and before 2013).

(3) A qualifying integrated gasification combined cycle technology unit, with or without fuel or chemical co-production, is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,500 Btu if the unit is placed in service after 2008 and before 2013).

(4) An other qualifying technology unit is a unit that uses any other technology and satisfies the design net heat rates of a qualifying advanced pulverized coal or atmospheric fluidized bed combustion technology unit.

Any qualifying advanced clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. A qualifying advanced clean coal technology unit must use at least 75 percent coal to produce at least 50 percent of its thermal output as electricity. In addition, a qualifying advanced clean coal technology unit must meet certain carbon emissions requirements. For units using design coal with a heat content of not more than 9,000 Btu per pound, the carbon emission rate must be less than 0.60 pound of carbon per kilowatt hour (0.51 if the unit qualifies as an other technology unit). For units using design coal with a heat content in excess of 9,000 Btu per pound, the carbon emission rate must be less than 0.54 pound of carbon per kilowatt hour (0.459 if the unit qualifies as an other technology unit).

To be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 6,000 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 6,000 megawatts of capacity, not more than 1,500 megawatts in total and not more than 750 megawatts in years prior to 2009 shall be allocated to units using advanced pulverized coal or atmospheric fluidized bed combustion technology. From the potential pool of 6,000 megawatts of capacity, not more than 750 megawatts in total and not more than 375 megawatts in years prior to 2009 shall be allocated to units using pressurized fluidized bed combustion technology. From the potential pool of 6,000 megawatts of capacity, not more than 3,000 megawatts in total and not more than 1,250 megawatts in years prior to 2009 shall be allocated to units using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 6,000 megawatts of capacity, not more than 750 in total and not more than 375 megawatts in years prior to 2009 shall be allocated to any other technology unit.

<u>Effective date</u>.--The provision is effective for property placed in service after the date of enactment.

3. Credit for production from advanced clean coal technology (secs. 2212 and 2221 of Senate amendment)

<u>Present Law</u>

Present law does not provide a production credit for electricity generated at units that use coal as a fuel. However, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste units placed in service prior to January 1, 2002 (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5-cent figure is indexed for inflation and equals 1.8 cents for 2002. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The production tax credit is a component of the general business credit (sec. 38(b)(1)).

House Bill

No provision.

Senate Amendment

In general

The Senate amendment creates a production credit for electricity produced from any qualified advanced clean coal technology electricity generation unit that qualifies for the investment credit for qualifying clean coal technology units, as described above. Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) will be eligible to obtain certifications from the Secretary of the Treasury (as described below) for each of these credits and sell, trade, or assign the credit to any taxpayer. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent trades are not permitted.

Value of production credit for electricity produced from qualifying advanced clean coal technology

The taxpayer may claim a production credit on the sum of each kilowatt-hour of electricity produced and the heat value of other fuels or chemicals produced by the taxpayer at the unit.[66] The taxpayer may claim the production credit for the 10-year period commencing with the date the qualifying unit is placed in service (or the date on which a conventional unit was retrofitted or repowered). The value of the credit varies depending upon the year the unit is placed in service, whether the unit produces solely electricity or electricity and fuels or chemicals, and the rated thermal efficiency of the unit. In addition, the value of the credit is reduced for the second five years of eligible production. The maximum value of the production credit from any qualifying unit during the first five years of production is $0.014 per kilowatt-hour and the minimum value is $0.001. During the second five years of production from a qualifying unit, the maximum value of the production credit is $0.0115 and the minimum value is $0.001. The value of the credit is indexed for inflation occurring after 2002 with the first potential adjustment in 2004.

Effective date

The Senate amendment is effective for electricity sold after the date of enactment.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Amortization of pollution control facilities (sec. 169 of the Code)

Present Law

In general, a taxpayer may elect to recover the cost of any certified pollution control facility over a period of 60 months.[67] A certified pollution control facility is defined as a new, identifiable treatment facility which (1) is used in an existing plant in operation before January 1, 1976, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes or heat; and (2) which does which does not lead to a significant increase in output or capacity, a significant extension of useful life, or a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility. Certification is required by appropriate State and Federal authorities that the facility comply with appropriate standards.

For a pollution control facility with a useful life greater than 15 years, only the basis attributable to the first 15 years is eligible to be amortized over a 5-year period.[68] The remaining basis is depreciable under the regular rules for depreciation. In addition, a corporate taxpayer must reduce the amount of basis eligible for the 60-month recovery by 20 percent.[69] Such reduction is depreciable under the regular rules for depreciation.

House Bill

No provision.

Senate Amendment

No provision.

[67] Sec. 169. For purposes of the alternative minimum tax, such property is recovered using the straight-line method over its general recovery period (for property placed in service prior to 1999 and after 1986 such property is recovered using the alternative system of depreciation contained in section 168(g)).

[68] The amount attributable to the first 15 years is equal to an amount which bears the same ratio to the portion of the adjusted basis of such facility, which would be eligible for amortization but for the application of this rule, as 15 bears to the number of years of useful life of such facility.

[69] Sec. 291(a)(5).

Conference Agreement

The conference agreement expands the ability to recover certified pollution control facilities over 60 months by repealing the requirement that only a certified pollution control facility used in connection with a plant in operation before January 1, 1976 qualify. Thus, a certified pollution control facility used in connection with a plant or other property that began operation after January 1, 1976, will generally be eligible for recovery over 60 months.[70] In addition, the conference agreement shortens the recovery period for a certified pollution control facility used in connection with a plant or other property in operation before January 1, 1976, to 36 months (from 60 months) if no allocation is made under section 48A(f) (as added by another provision of the conference agreement). The conference agreement does not alter the present law limitation on the benefits of the provision for corporate taxpayers and pollution control facilities with a useful life greater than 15 years.

Effective date.–The provision applies to facilities placed in service after the date of enactment.

5. Eligible integrated gasification combined cycle technology unit treated as five-year property (sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[71] Electric utility steam production plant property, which includes combustion turbines operated in a combined cycle with a conventional steam unit, is assigned a 20-year recovery period and a class life of 28 years.

House Bill

No provision.

Senate Amendment

No provision.

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[70] In the case of a facility used in connection with a plant or other property to which an amount is allocated under section 48A(f) (as added by another provision in the conference agreement) the 60-month amortization period only applies if such plant or other property was in operation before January 1, 1976.

[71] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

Conference Agreement

The conference agreement establishes a statutory 5-year recovery period and a class life of 20 years for an eligible integrated gasification combined cycle technology unit that receives an allocation of the clean coal technology credit.[72] An eligible integrated gasification combined cycle technology unit is defined as a clean coal technology unit using integrated gasification combined cycle technology, with or without fuel or chemical co-production, which meets a certain design heat rate and net thermal efficiency.[73]

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

[72] Section 48A as added by another provision of the conference agreement.

[73] The design heat rate and net thermal efficiency standards are defined in section 48A(e)(4)(A) and (B) as added by another provision of the conference agreement.

E. High Volume Natural Gas Provisions

1. High volume natural gas pipe treated as seven-year property (sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[74] . Asset class 46.0, describing assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors, are assigned a class life of 22 years and a recovery period of 15 years.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement establishes a statutory seven-year recovery period and a class life of 22 years for any high volume natural gas pipe the original use[75] of which commences after the date of enactment. High volume natural gas pipe is defined as a pipe which has an interior diameter at least 42 inches and which is part of a natural gas pipeline system. Such property includes any related equipment and appurtenances used in connection with such pipe. In

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[74] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[75] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, if on April 13, 2004, a taxpayer buys from ACM for $20,000,000 a 42-inch natural gas pipeline that has been previously used by ACM. Subsequent to the purchase, the taxpayer makes an expenditure on the property of $5,000,000 for new 42-inch pipe that is required to be capitalized. Regardless of whether the $5,000,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original use" requirement and would be eligible for the reduced recovery period. No part of the $20,000,000 purchase price qualifies for the reduced recovery period.

addition, the conference agreement provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

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

2. Credit for production of Alaska natural gas (sec. 2503 of Senate amendment)

Present Law

Present law does not provide a credit for conventional production of natural gas or delivery of fuels to a pipeline. However, certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(2) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

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

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

House Bill

No provision.

Senate Amendment

The Senate amendment provides a credit per million British thermal units (Btu) of natural gas for Alaska natural gas entering a pipeline during the 15-year period beginning the later of January 1, 2010 or the initial date for the interstate transportation of Alaska natural gas. Taxpayers may claim the credit against both the regular and minimum tax.

The credit amount for any month is the excess of $3.25 (indexed for inflation) per million Btu of natural gas over the average monthly price for that month for Alaska natural gas at the

AECO C Hub in Alberta, Canada. Inflation adjustments in the $3.25 amount will be made by reference to changes in the GDP implicit price deflator for changes occurring after the first year in which the credit may be claimed.

If in any month commencing three years after the first year in which the credit may be claimed the average monthly price for that month for Alaska natural gas at the AECO C Hub in Alberta, Canada, exceeds $4.875 (indexed for inflation) per million Btu, any prior credits claimed are recaptured by increasing the taxpayer's tax liability by the lesser of the excess of the average monthly price for that month for Alaska natural gas at the AECO C Hub over $4.875 (indexed for inflation) per million Btu or the aggregate amount of credit claimed for Alaska natural gas in all prior years.

Alaska natural gas is any gas derived from an area of the State of Alaska lying north of 64 degrees North latitude generally from the area known as the "North Slope of Alaska," but not including the Alaska National Wildlife Refuge.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Enhanced oil recovery credit for certain gas processing facilities (sec. 43 of the Code)

Present Law

The taxpayer may claim a credit equal to 15 percent of enhanced oil recovery costs. Qualified enhanced oil recovery costs include costs of depreciable tangible property that is part of an enhanced oil recovery project, intangible drilling and development costs with respect to an enhanced oil recovery project, and tertiary injectant expenses incurred with respect to an enhanced oil recovery project. The credit is phased out when oil prices exceed a threshold amount.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides that expenses in connection with the construction of any qualifying natural gas processing plant capable of processing one trillion British thermal units of natural gas into a natural gas pipeline system on a daily basis are qualified enhanced oil recovery costs eligible for the enhanced oil recovery credit. A qualifying natural gas processing plant also must produce carbon dioxide for re-injection into a producing oil or gas field.

Effective date.–The provision is effective for costs paid or incurred in taxable years beginning after 2003.

IV. ADDITIONAL PROVISIONS

A. Extension of Tax Incentives for Energy-Related Businesses on Indian Reservations (sec. 2501 of the Senate amendment and sec. 168 of the Code)

Present Law

The following tax incentives are available for businesses within Indian reservations.

Accelerated depreciation

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

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer, and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in service for purposes of conducting gaming activities. Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation.

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation is available with respect to property placed in service on or after January 1, 1994, and before December 31, 2004.

Indian employment credit

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

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before December 31, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the accelerated depreciation incentive to property placed in service before January 1, 2006, and the Indian employment credit incentive to taxable years beginning before January 1, 2006.

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

Conference Agreement

The conference agreement extends the accelerated depreciation incentive for property placed in service before January 1, 2006, as part of a facility for: (1) the generation or transmission of electricity (including any qualified energy resource as defined in section 45(c) for purposes of the credit for electricity produced from certain renewable resources), (2) an oil or gas well, (3) the transmission or refining of oil or gas, or (4) the production of any qualified fuel (as defined for purposes of the credit for producing fuel from a nonconventional source).

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

B. GAO Study
(sec. 2502 of the Senate amendment)

<u>Present Law</u>

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

<u>House Bill</u>

No provision.

<u>Senate Amendment</u>

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

The bill directs the Comptroller General to submit annual reports to Congress beginning not later than December 31, 2002.

<u>Effective date</u>.–The provision is effective on the date of enactment.

<u>Conference Agreement</u>

The conference agreement does not include the Senate amendment provision.

C. Treatment of Certain Dispositions of Dairy Property to Implement Bovine Tuberculosis Eradication Program (sec. 2505 of the Senate amendment)

Present Law

Generally, a taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (generally the period ending two years after the end of the taxable year in which the first gain on the conversion is realized) property similar or related in service or use.

House Bill

No provision.

Senate Amendment

The Senate amendment extends involuntary conversion treatment to qualified dispositions of dairy property pursuant to the bovine tuberculosis eradication program. Treats any property acquired and held by the taxpayer either for productive use in a trade or business or for investment as property similar or related in use to the converted property. Extend the applicable acquisition period from two to four years and permits replacement property to be acquired from related parties. In addition to deferring gain, the provision also permits an ordinary loss equal to the adjusted basis of the converted property.

Finally, the provision allows expensing for amounts paid or incurred by the taxpayer to convert any real property into unimproved land pursuant to the bovine tuberculosis eradication program.

Effective date.–Effective for dispositions made and amounts received in taxable years beginning after May 22, 2001, but shall not apply to dispositions made after December 31, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

D. Expand Exemption from Aviation Fuels Excise Taxes for Aerial Applicators (sec. 2506 of the Senate amendment)

Present Law

Excise taxes are imposed on aviation gasoline (19.4 cents per gallon) and jet fuel (21.9 cents per gallon) (secs. 4081 and 4091). Fuel used on a farm for farming purposes is exempt from tax. Aerial applicators (crop dusters) are allowed to claim the exemption on behalf of farm owners and operators, e.g., in the case of aviation gasoline if the owners or operators give written consent to the aerial applicators. This exemption applies only to fuel consumed in the airplane while operating over the farm, i.e., fuel consumed traveling to and from the farm is not exempt.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the present-law exception to include fuel used between farms and base airfields, and provides that the aerial applicator is the exclusive party entitled to the refund.

Effective date.–The provision is effective for fuel use and air transportation after December 31, 2001 and before January 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Modification of Rural Airport Definition (sec. 2507 of the Senate amendment)

Present Law

Most domestic air passenger transportation is subject to a two-part excise tax. First, an *ad valorem* tax is imposed at the rate of 7.5 percent of the amount paid for the transportation. Second, a flight segment tax of $3.00 per segment is imposed. The flight segment component of the tax does not apply to segments to or from qualified "rural airports." A rural airport is defined as an airport that (1) in the second preceding calendar year had fewer than 100,000 commercial passenger departures, and (2) either (a) is not located within 75 miles of another airport that had more than 100,000 such departures in that year, or (b) is eligible for payments under the Federal "essential air service" program.

House Bill

No provision.

Senate Amendment

The provision expands the definition of qualified rural airport to include an airport that (1) is not connected by paved roads to another airport and (2) had fewer that 100,000 passengers departing by air during the second preceding calendar year.

Effective date.–The provision is effective for calendar years beginning after 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Exempt Transportation by Seaplane From Ticket Taxes (sec. 2508 of the Senate amendment)

Present Law

Most domestic air passenger transportation is subject to a two-part excise tax. First, an *ad valorem* tax is imposed at the rate of 7.5 percent of the amount paid for the transportation. Second, a flight segment tax of $3.00 per segment is imposed. Noncommercial aviation is subject to a higher fuel excise excise tax, but not the ticket tax.

Commercial aviation also is subject to a 4.4-cents-per-gallon fuels excise tax.

House Bill

No provision.

Senate Amendment

The Senate amendment exempts seaplane flights from the taxes on transportation of persons and property by air.

Effective date.–The provision is effective for calendar years beginning after 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Credit for Taxpayers Owning Commercial Power Takeoff Vehicles (sec. 2009 of the Senate amendment)

Present Law

If gasoline is used in an off-highway business use, the ultimate purchaser of the gasoline is entitled to a credit or refund of excise taxes paid in respect of the gasoline.[76] No credit or payment may be claimed in respect of gasoline used in a commercial highway vehicle solely by reason of the fact that the propulsion motor in the vehicle also is used for a purpose other than to propel the vehicle.[77] Thus, if the propulsion motor of a highway vehicle also operates special equipment, such as a mixing unit on a concrete mixer or a pump for discharging fuel from a tank truck, by means of a power takeoff or power transfer, no credit or payment may be claimed in respect of the gasoline used to operate the special equipment, even though the special equipment is mounted on the highway vehicle.[78]

If the highway vehicle is equipped with a separate motor to operate the special equipment, credit or refund payment may be claimed in respect of gasoline used in the separate motor. For example, if a separate motor is used to operate a refrigeration unit, pump, generator or mixing unit, the ultimate purchaser could seek a refund with respect to the gasoline used in that separate motor. If the gasoline used in a separate motor is drawn from the same tank as the one which supplies gasoline for the propulsion of the highway vehicle, the determination as to the quantity of gasoline used in the separate motor operating the special equipment is based on operating experience and supported by records.[79]

House Bill

No provision.

Senate Amendment

The provision provides a yearly $250-per-vehicle income tax credit to business owners of certain highway vehicles that consume fuel for both transportation and in non-transportation-related equipment, using a single motor. Specifically, the provision covers vehicles (1) designed to engage in the daily collection of refuse or recyclables from homes or businesses and is equipped with a mechanism under which the vehicles propulsion engine provides the power to operate a load compactor, ("refuse collection trucks") or (2) designed to deliver ready mixed concrete on a daily basis and is equipped with a mechanism under which the vehicles propulsion engine provides the power to operate a mixer drum to agitate and mix the product en route to the

[76] Sec. 6421(a).

[77] Treas. Reg. sec. 48.6421-1(d)(2).

[78] *Id.*

[79] Treas. Reg. sec. 48.6421-1(d)(3).

delivery site ("concrete mixers"). Governmental vehicles and those owned by tax-exempt organizations are not eligible for the credit. The credit expires after the calendar year 2004.

The provision further requires that by January 1, 2005, the Treasury provide by regulation a method for exempting refuse collection trucks and concrete mixers from the fuels excise tax on fuel used to power equipment attached to these vehicles.

Effective date.–The provision is effective for taxable years beginning after the date of enactment through 2004.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

H. Payment of Dividends on Stock of Cooperatives Without Reducing Patronage Dividends (sec. 1388 of the Code)

Present Law

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

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[80] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

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

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

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

I. Distributions from Publicly Traded Partnerships Treated as Qualifying Income of Regulated Investment Company (secs. 851 and 469(k) of the Code)

Present Law

Treatment of regulated investment companies

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

One of the RIC qualification requirements is that at least 90 percent of the RIC's gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies (sec. 851(b)(2)). Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the "look-through" rule for partnership income) (sec. 851(b)). Under present law, no distinction is made under this rule between a publicly traded partnership (that is treated as a partnership for Federal tax purposes) and any other partnership.

The RIC qualification rules include limitations on the ownership of assets and on the composition of the RIC's assets (sec. 851(b)(3)). Under the ownership limitation, at least 50 percent of the value of the RIC's total assets must be represented by cash, government securities and securities of other RICs, and other securities; however, in the case of such other securities, the RIC may invest no more than 5 percent of the value of the total assets of the RIC in the securities of any one issuer, and may hold no more than 10 percent of the outstanding voting securities of any one issuer. Under the limitation on the composition of the RIC's assets, no more than 25 percent of the value of the RIC's total assets may be invested in the securities of any one issuer (other than Government securities), or in securities of two or more controlled issuers in the same or similar trades or businesses. These limitations generally are applied at the end of each quarter (sec. 851(d)).

Treatment of publicly traded partnerships

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

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

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

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

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

A publicly traded partnership to which the provision applies is a publicly traded partnership described in section 7704(b) other than one that would satisfy the 90-percent gross income requirements for publicly traded partnerships if qualifying income included only income that is qualifying income described in section 851(b)(2)(A) for a RIC (i.e., income that is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies).

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

The conferees intend that the provision not be used to avoid tax on the partnership's income in the hands of the mutual fund shareholders that would be subject to tax (e.g., unrelated business income tax) or to withholding (e.g., withholding on foreign partners) if they held the partnership interest directly. The conferees expect that guidance issued by the Treasury Department with respect to the provision will provide rules that carry out this intent.

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

J. Suspension of Duties on Ceiling Fans (Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

A 4.7-percent *ad valorem* customs duty is collected on imported ceiling fans from all sources.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement suspends the present customs duty applicable to ceiling fans through December 31, 2005.

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

K. Suspension of Duties on Nuclear Steam Generators (Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

Nuclear steam generators, as classified under heading 9902.84.02 of the Harmonized Tariff Schedule of the United States, enter the United States duty free until December 31, 2006. After December 31, 2006, the duty on nuclear steam generators returns to the column 1 rate of 5.2 percent under subheading 8402.11.00 of the Harmonized Tariff Schedule of the United States.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement extends the present-law suspension of customs duty applicable to nuclear steam generators through December 31, 2008.

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

L. Suspension of Duties on Nuclear Reactor Vessel Heads (Chapter 99, II of the Harmonized Tariff Schedule of the United States)

Present Law

According to section 5202 of the Trade Act of 2002, nuclear vessel heads are classified under subheading 8401.40.00 of the Harmonized Tariff Schedule of the United States and enter the United States with a column 1 duty rate of 3.3 percent.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement temporarily suspends the present customs duty applicable to nuclear reactor vessel heads for column 1 countries through December 31, 2007.

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

M. Brownfields Demonstration Program for Qualified Green Building and Sustainable Design Projects (secs. 142 and 146 of the Code)

Present Law

Tax-exempt bonds

In general

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

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately owned and/or operated low-income rental housing;[81] and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

[81] Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

With the exception of qualified 501(c)(3) bonds, private activity bonds may not be issued to finance working capital requirements of private businesses. In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits.

Several additional restrictions apply to the issuance of tax-exempt bonds. First, private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds are not retired within 90 days of issuance of the refunding bonds.

Issuance of private activity bonds is subject to restrictions on use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores) and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Additionally, the term of the bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds. Present and prior law precludes substantial users of property financed with private activity bonds from owning the bonds to prevent their deducting tax-exempt interest paid to themselves. Finally, owners of most private-activity-bond-financed property are subject to special "change-in-use" penalties if the use of the bond-financed property changes to a use that is not eligible for tax-exempt financing while the bonds are outstanding.

House bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The bill creates a new category of tax-exempt bonds, the qualified green building and sustainable design project bond. A qualified green building and sustainable design project bond is defined as any bond issued as part of an issue that finances a project designated by the Secretary, after consultation with the Administrator of the Environmental Protection Agency (the "Administrator") as a green building and sustainable design project that meets the following requirements: (1) at least 75 percent of the square footage of the commercial buildings that are part of the project is registered for the U.S. Green Building Council's LEED certification and is reasonably expected (at the time of designation) to meet such certification[82]; (2) the project

[82] The LEED ("Leadership in Energy and Environmental Design) Green Building Rating System is a voluntary, consensus-based national standard for developing high-performance sustainable buildings. Registration is the first step toward LEED certification. Actual certification requires that the applicant project satisfy all prerequisites and receive a

includes a brownfield site[83]; (3) the project receives at least $5 million dollars in specific State or local resources; and (4) the project includes at least one million square feet of building or 20 acres of land.

Each project must be nominated by a State or local government within 180 days of enactment of this Act and such State or local government must provide written assurances that the project will satisfy certain eligibility criteria. Within 60 days after the end of the application period, the Secretary, after consultation with the Administrator, will designate the qualified green building and sustainable design projects. At least one of the projects must be in or within a ten-mile radius of an empowerment zone (as defined under section 1391 of the Code) and at least one must be in a rural State.[84] A project shall not be designated if such project includes a stadium or arena for professional sports exhibitions or games.

The Secretary, after consultation with the Administrator, shall also ensure that, in the aggregate, the projects designated shall: (1) reduce electric consumption by more than 150 megawatts annually as compared to conventional construction; (2) reduce daily sulfur dioxide emissions by at least 10 tons compared to coal generation power; (3) expand by 75 percent the domestic solar photovoltaic market in the United States (measured in megawatts) as compared to the expansion of that market from 2001 to 2002; and (4) use at least 25 megawatts of fuel cell energy generation.

Each application shall contain for each project a description of: (1) amount of electric consumption reduced as compared to conventional construction; (2) the amount of sulfur dioxide daily emissions reduced compared to coal generation; (3) the amount of gross installed capacity of the project's solar photovoltaic capacity measured in megawatts; and (4) the amount, measured in megawatts, of the project's fuel cell energy generation. Each project application must also demonstrate that: (1) at least 75 percent of the square footage of the commercial buildings that are part of the project is registered for the U.S. Green Building Council's LEED certification and is reasonably expected (at the time of designation) to meet such certification; (2)

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minimum number of points to attain a LEED rating level. Commercial buildings, as defined by standard building codes are eligible for certification. Commercial occupancies include, but are not limited to, offices, retail and service establishments, institutional buildings (e.g. libraries, schools, museums, churches, etc.), hotels, and residential buildings of four or more habitable stories. <https://www.usgbc.org/LEED/Project/certprocess.asp>.

[83] For this purpose a brownfield site is defined by section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601), including a site described in subparagraph (D)(ii)(II)(aa) (relating to a site that is contaminated by petroleum or a petroleum product excluded from the definition of 'hazardous substance' under section 101.)

[84] The term "rural State" means any State that has (1) a population of less than 4.5 million according to the 2000 census; (2) a population density of less than 150 people per square mile according to the 2000 census; and (3) increased in population by less than half the rate of the national increase between the 1990 and 2000 censuses.

the project includes a brownfield site (as defined above); (3) the project receives at least $5 million dollars in specific State or local resources; (4) the project includes at least one million square feet of building or at least 20 acres of land; (5) the project is projected to provide permanent employment of at least 1500 full time equivalents (150 full time equivalents in rural States) when completed and construction employment of at least 1000 full time equivalents (100 full time equivalents in rural States)[85]; and (6) the net benefit of the qualified green building and sustainable design project tax-exempt financing provided will be allocated for (i) the purchase, construction, integration or other use of energy efficiency, renewable energy and sustainable design features of the project, (ii) compliance with LEED certification standards, and/or (iii) the purchase, remediation, foundation construction, and preparation of the brownfield site. Not later than 30 days after the completion of the project, each project must certify to the Secretary that the net benefit of the tax-exempt financing was used for the purposes described.

Qualified green building and sustainable design project bonds are not subject to the State bond volume limitations. There is a national limitation of $2 billion of bonds. The Secretary may allocate, in the aggregate, no more than $2 billion of bonds to qualified green building and sustainable design projects.

Any asset financed with qualified green building and sustainable design project bonds is ineligible for any credit or deduction established or extended under the Energy Tax Policy Act of 2003. In addition, each issuer shall maintain, on behalf of each project, an interest bearing reserve account equal to one percent of the net proceeds of any qualified green building and sustainable design project bond issued for such project. Not later than five years after the date of issuance, the Secretary, after consultation with the Administrator, shall determine whether the project financed with such bonds has substantially complied requirements and commitments described in the project application for designation, including certification. If the Secretary, after such consultation, certifies that the project has substantially complied with requirements and commitments, amounts in the reserve account, including all interest, shall be released to the project. If the Secretary determines that the project has not substantially complied with such requirements and commitments, amounts in the reserve account, including all interest, shall be paid to the United States Treasury.

Qualified green building and sustainable design project bonds may be currently refunded if certain conditions are met, but cannot be advance refunded.

Effective date.–The provisions are effective for bonds issued after the date of enactment and before October 1, 2009.

[85] The application is to include an independent analysis that describes the project's economic impact, including the amount of projected employment.

V. TAX COMPLEXITY ANALYSIS

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code and that have "widespread applicability" to individuals or small businesses.