108TH CONGRESS } SENATE { REPORT
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JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT

November 7, 2003.—Ordered to be printed

Mr. GRASSLEY, from the Committee on Finance,
submitted the following

REPORT

together with

ADDITIONAL AND DISSENTING VIEWS

[To accompany S. 1637]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (S. 1637) to amend the Internal Revenue Code of 1986 to comply with the World Trade Organization findings on the FSC/ETI benefit in a manner that preserves jobs and production activities in the United States, to reform and simplify the international taxation rules of the United States, and for other purposes, reports favorably thereon with an amendment in the nature of a substitute and recommends that the bill, as amended, to pass.

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I. LEGISLATIVE BACKGROUND

<u>Overview</u>

The Committee on Finance marked up S. 1637 (the "Jumpstart Our Business Strength (JOBS) Act") on October 1, 2003, and ordered the bill favorably reported by a vote of 19 Ayes and 2 Nays.

<u>Hearings</u>

The Committee held public hearings during the 108th Congress on various topics related to the provisions included in the bill.

- An Examination of U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations (July 15, 2003)
- An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Based Operations (July 8, 2003)
- Enron: The Joint Committee on Taxation's Investigative Report (February 13, 2003)
- Revenue Proposals in the President's FY 2004 Budget (February 5, 2003)

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

A. Repeal of Extraterritorial Income Regime

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

Present Law

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 In response to this WTO finding, the United States repealed the FSC rules and enacted a new regime, under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.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

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

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or

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

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

rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

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

Reasons for Change

While recognizing that there are problems with the WTO dispute settlement system that need to be addressed, the Committee believes it is important that the United States, and all members of the WTO, make every effort to come into compliance with their WTO obligations. The Appellate Body has found that the ETI regime constitutes a prohibited export-contingent subsidy contrary to U.S. obligations under the WTO. The Committee believes that the replacement tax regime provided for in this bill is consistent with U.S. obligations under the WTO and will bring the United States into compliance with the Appellate Body decision. To mitigate the economic impact of repealing the ETI provisions, the Committee believes that it is necessary and appropriate to provide a transition to complement the phase-in of the replacement tax regime included in this bill. In developing a transition for this bill, the Committee was guided by the latitude demonstrated by the United States toward the European Union in the context of the so-called "Bananas" dispute. With respect to both the Bananas and FSC/ETI disputes, the efforts to comply with the applicable WTO decisions entail the sizable disruption of commercial relations and expectations that developed over the course of decades.

In the Bananas case, the United States joined other complainants in challenging the European Union's banana import regime under the WTO. The United States and the European Union eventually reached an Understanding to resolve the WTO dispute over the European Union's import regime for bananas. By virtue of that Understanding, the European Union imposed a transitional banana import regime that will not end until seven years after the initial deadline established by the WTO for the European Union to come into compliance. The European Union subsequently obtained from the Doha Ministerial Conference of the WTO a waiver from paragraphs 1 and 2 of Article XIII of the GATT 1994 with respect to its transitional banana import regime. That waiver was necessary for the transitional banana import regime to remain consistent with the WTO obligations of the European Union. The United States did not object to that waiver. The United States also did not object to a second waiver granted to the European Union by the Doha Ministerial Conference, under which paragraph 1 of Article I of the GATT 1994 was waived with respect to the European Union's preferential tariff treatment for products originating in the African, Caribbean and Pacific ("ACP") Group of States. This latter waiver extends until December 31, 2007. As a result of the foregoing waivers consented to by the United States, the European Union will not be required to grant non-discriminatory market access for bananas until a full nine years after the compliance deadline established by the WTO.[3] The Committee notes that the transition provided for in this bill expires well before the nine-year anniversary of the compliance deadline established by the WTO with respect to the FSC regime. Just as the European Union approached the issue of compliance in the Bananas dispute, the Committee believes that it is necessary and appropriate to provide a reasonable transition period during which the affected businesses may adjust to the new environment following repeal of the ETI regime.

In developing the transition provided for in this bill, it is also the intent of the Committee to eliminate objections to such transition, and avoid the need to seek any waiver from the WTO for such transition, by removing any element of export contingency from the transition. Thus, eligibility for the transition deduction under this bill is entirely decoupled from actual exports during the transition period. Consequently, a principal rationale for the European Union's challenge to the FSC/ETI regimes is not implicated by the transition.

A second transitional element provided for in this bill is the grandfathering of existing contracts entered into under the FSC and ETI tax regimes. These contracts are comprised primarily of long-term leasing arrangements. These arrangements typically entail a U.S. lessor purchasing the manufactured good from the manufacturer and subsequently entering into a long-term lease with a foreign lessee. Under these circumstances, the FSC/ETI tax benefit accrues to the lessor rather than the manufacturer of the leased good. The lessor must report the FSC/ETI tax benefit immediately for purposes of financial statement accounting under generally accepted accounting principles ("GAAP").

Leasing is a service and is recognized as such within the WTO. The provision of non-discriminatory subsidies to service suppliers is not prohibited under the WTO General Agreement on Trade in Services ("GATS"). Thus, an extension of FSC/ETI benefits for suppliers of leasing services under existing long-term contracts does not appear to be inconsistent with the WTO obligations of the United States under GATS. Moreover, the extension of FSC/ETI benefits for existing long-term leasing contracts will have no effect on future exports. Accordingly, a principal rationale for the European Union's challenge to the FSC/ETI regimes is not implicated because future trade patterns will not be distorted by virtue of the grandfather clause. On the other hand, the absence of a grandfather clause for existing long-term contracts would effectively dictate winners and losers based upon preexisting contractual relationships, and would inflict additional harm by forcing lessors to restate their financial statements. Neither of those outcomes is equitable in the view of the Committee, nor did the architects of the WTO dispute settlement system contemplate such punitive results.

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[3] The Committee notes with concern that, to date, the European Union has failed to publish full details of its enlargement policy for the accession of ten new members in May 2004. In particular, the European Union has not announced the post-enlargement licensing application process for bananas. This lack of transparency may well result in the disruption of trade in bananas, to the point where the mutually agreed-upon terms of the Understanding between the United States and the European Union for a transitional banana import regime are not fully adhered to after enlargement. The Committee intends to monitor this situation closely.

Accordingly, the Committee believes it is necessary and appropriate to continue to provide FSC and ETI tax benefits to existing long-term contracts that currently benefit from the FSC/ETI tax regimes.

The Committee also believes that Congress should use the opportunity afforded by repealing the ETI regime to enact a replacement tax regime that benefits all domestic manufacturers, including small manufacturing firms, as well as to enact changes that rationalize the international tax laws and strengthen the international competitiveness of U.S. businesses. In addition, the Committee believes that the history of the ETI regime and its predecessors demonstrates the need for WTO members to reexamine the treatment of various tax systems under the WTO rules.

Explanation of Provision

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

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

The provision also provides a deduction for taxable years of certain corporations ending after the date of enactment of the provision and beginning before January 1, 2007.[4] The amount of the deduction for each such taxable year is equal to a specified percentage of the amount that, for the taxable year of a corporation beginning in 2002, was excludable from the gross income of the corporation under the extraterritorial income exclusion provisions or was treated by the corporation as exempt foreign trade income of related FSCs from property acquired by the FSCs from the corporation.[5] However, this aggregate amount does not include any amount attributable

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

to a transaction involving a lease by the corporation unless the corporation manufactured or produced (in whole or in part) the leased property.

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

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

Effective Date

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

2. Deduction relating to income attributable to United States production activities (sec. 102 of the bill and new sec. 199 of the Code)

Present Law

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

Reasons for Change

The Committee believes that creating new jobs is an essential element of economic recovery and expansion, and that tax policies designed to foster job creation also must reverse the recent declines in manufacturing sector employment levels. To accomplish this objective, the Committee believes that Congress should enact tax laws that enhance the ability of domestic businesses, and domestic manufacturing firms in particular, to compete in the global marketplace. The Committee further believes Congress should enact tax laws that enable small businesses to maintain their position as the primary source of new jobs in this country.

The Committee understands that simply repealing the ETI regime will diminish the prospects for recovery from the recent economic downturn by the manufacturing sector. Consequently, the Committee believes that it is necessary and appropriate to replace the ETI

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

regime with new provisions that reduce the tax burden on domestic manufacturers, including small businesses engaged in manufacturing.

Explanation of Provision

In general

The provision provides a deduction equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2008, the deduction is nine percent of such income. For taxable years beginning in 2003, 2004, 2005, 2006, 2007 and 2008, the deduction is one, one, two, three, six, and six percent of income, respectively. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during such taxable year.[6] In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer.

Qualified production activities income

In general, "qualified production activities income" is the modified taxable income[7] of a taxpayer that is attributable to domestic production activities. Income attributable to domestic production activities generally is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;[8] (2) other deductions, expenses,

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

[7] "Modified taxable income" is taxable income of the taxpayer computed without regard to the deduction provided by the provision. Qualified production activities income is limited to the modified taxable income of the taxpayer.

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

or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[9]

For taxable years beginning before 2013, qualified production activities income is reduced by virtue of a fraction (not to exceed one), the numerator of which is the value of the domestic production of the taxpayer and the denominator of which is the value of the worldwide production of the taxpayer (the "domestic/worldwide fraction").[10] For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is reduced by 25, 50, and 75 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

Domestic production gross receipts

"Domestic production gross receipts" are gross receipts of a taxpayer that are derived in the actual conduct of a trade or business from any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the taxpayer within the United States or any possession of the United States.[11] "Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(3) or (4) of the Code.[12] However, qualifying production property does not include: (1) consumable

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

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

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

[12] For purposes of the definition of qualified production property, property described in section 168(f)(3) or (4) of the Code includes underlying copyrights and trademarks. In addition,

property that is sold, leased or licensed as an integral part of the provision of services; (2) oil or gas (other than certain primary products thereof);[13] (3) electricity; (4) water supplied by pipeline to the consumer; (5) utility services; and (6) any film, tape, recording, book, magazine, newspaper or similar property the market for which is primarily topical or otherwise essentially transitory in nature.

Other rules

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

With respect to domestic production activities of an S corporation, partnership, estate, trust or other passthrough entity (other than an agricultural or horticultural cooperative), the deduction under this provision generally is determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity.[14] The Treasury Secretary is directed to prescribe rules for the application of this provision to passthrough entities, including reporting requirements and rules relating to restrictions on the allocation of the deduction to taxpayers at the partner or similar level.

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the provision provides the same treatment of qualified production activities income derived from products marketed through cooperatives as it provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income). In addition, the provision provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an

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gross receipts from the sale, exchange, lease, rental, license or other disposition of property described in section 168(f)(3) or (4) are treated as domestic production gross receipts if more than 50 percent of the aggregate development and production costs of such property are incurred by the taxpayer within the United States. For this purpose, property that is acquired by the taxpayer after development or production has commenced, but before such property generates substantial gross receipts, shall be treated as developed or produced by the taxpayer.

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

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

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

Alternative minimum tax

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

Coordination with ETI repeal

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

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

Effective Date

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

TITLE II - INTERNATIONAL TAX PROVISIONS

A. International Tax Reform

1. Revision of foreign tax credit carryforward and carryback periods (sec. 201 of the bill and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to a portion of the taxpayer's U.S. tax which portion is calculated by multiplying the taxpayer's total U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) and the denominator of which is the taxpayer's worldwide taxable income for the year.[15]

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

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

Reasons for Change

The Committee is concerned that excessive double taxation of foreign earnings may result from the expiration of foreign tax credits under present law. The Committee believes that the purposes of the foreign tax credit would be better served by providing a larger window within which credits may be used, thereby reducing the likelihood that credits may expire.

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[15] Section 904(a).

Explanation of Provision

The provision extends the excess foreign tax credit carryforward period to twenty years and limits the carryback period to one year.

Effective Date

The extension of the carryforward period is effective for excess foreign tax credits that may be carried to any taxable years ending after the date of enactment of the provision; the limited carryback period is effective for excess foreign tax credits arising in taxable years beginning after the date of enactment of the provision.

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

Present Law

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

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).[16] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach).

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

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

Reasons for Change

The Committee believes that significant simplification can be achieved by eliminating the requirement that taxpayers segregate the earnings and profits of 10/50 companies on the basis of when such earnings and profits arose.

Explanation of Provision

The provision generally applies the look-through approach to dividends paid by a 10/50 company regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated[17] and eliminates the separate basket for dividends from 10/50 companies. If the Secretary of the Treasury determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 company to the proper foreign tax credit limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes.[18]

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

Effective Date

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

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

Present Law

In general

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

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[17] This look-through treatment also applies to dividends that a controlled foreign corporation receives from a 10/50 company and then distributes to a U.S. shareholder.

[18] The Committee expects that Treasury will reconsider the operation of the foreign tax credit regulations to ensure that the high tax income rules apply appropriately to dividends treated as passive category income because of inadequate substantiation.

tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of such items.

Foreign tax credit

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

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

Reasons for Change

The Committee does not view the foreign tax credit as a tax preference item, and thus views the 90-percent limit under present law as inappropriate.

Explanation of Provision

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

Effective Date

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

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

Present Law

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

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

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

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

Losses for any taxable year in separate foreign limitation categories (to the extent that they do not exceed foreign income for the year) are apportioned on a proportionate basis among (and operate to reduce) the foreign income categories in which the entity earns income in the loss year. A separate limitation loss recharacterization rule applies to foreign losses apportioned to foreign income pursuant to the above rule. If a separate limitation loss was apportioned to income subject to another separate limitation category and the loss category has income for a subsequent taxable year, then that income (to the extent that it does not exceed the aggregate separate limitation losses in the loss category not previously recharacterized) must be recharacterized as income in the separate limitation category that was previously offset by the loss. Such recharacterization must be made in proportion to the prior loss apportionment not previously taken into account.

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

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

Reasons for Change

The Committee believes that the overall foreign loss rules continue to represent sound tax policy, but that concerns of parity dictate that overall domestic loss rules be provided to address situations in which a domestic loss may restrict a taxpayer's ability to claim foreign tax credits.

Explanation of Provision

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

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

Any U.S.-source income recharacterized under the provision is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic losses, in a manner similar to the recharacterization rules for separate limitation losses.

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

Effective Date

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

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

Present Law

In general

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

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[19] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

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

Definition of affiliated group -- consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock

[19] However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

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

Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[20] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

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

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

Reasons for Change

The Committee observes that under present law, a U.S.-based multinational corporate group with a significant portion of its assets overseas must allocate a significant portion of its

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

interest expense to foreign-source income, which reduces the foreign tax credit limitation and thus the credits allowable, even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under foreign law. The Committee believes that this approach unduly limits such a taxpayer's ability to claim foreign tax credits and leaves it excessively exposed to double taxation of foreign-source income. The Committee believes that interest expense instead should be allocated using an elective "worldwide fungibility" approach, under which interest expense incurred in the United States is allocated against foreign-source income only if the debt-to-asset ratio is higher for U.S. than for foreign investments.

Explanation of Provision

In general

The provision modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[21] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[22]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[23] as well as all controlled foreign corporations that,

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[21] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account. It is anticipated that the Treasury Secretary will adopt regulations addressing the allocation and apportionment of interest expense on such indebtedness that follow principles analogous to those of existing regulations. Income from holding stock or indebtedness of another group member is taken into account for all purposes under the present-law rules of the Code, including the foreign tax credit provisions.

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

[23] The provision expands the definition of an affiliated group for interest expense allocation purposes to include certain insurance companies that are generally excluded from an

in the aggregate, either directly or indirectly,[24] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

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

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Financial institution group election

The provision allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group. Under the provision, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[25] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal

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affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)).

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

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

purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the provision provides anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The provision provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, or address changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2008.

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

Present Law

Subpart F foreign personal holding company income

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

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

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[26] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[27]

Hedging transactions

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[28] The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations.[29]

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

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

[28] Sec. 1221(a)(7).

[29] Sec. 1221(b)(2)(A).

Reasons for Change

The Committee believes that exceptions from subpart F foreign personal holding company income for commodities hedging transactions and active business sales of commodities should be modified to better reflect current active business practices and, in the case of hedging transactions, to conform to recent tax law changes concerning hedging transactions generally.

Explanation of Provision

The provision modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the provision, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this provision, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2).[30]

The provision also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the provision, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[31]

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[30] Sec. 1221(a)(7) and (b)(2)(B).

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

For purposes of applying the requirements for active business gains or losses from commodities sales to qualify for exclusion from the definition of foreign personal holding company income, the provision also provides that commodities with respect to which gains or losses are not taken into account as foreign personal holding company income by a regular dealer in commodities (or financial instruments referenced to commodities) are not taken into account in determining whether substantially all of the dealer's commodities are comprised of the property described above.

Effective Date

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

B. International Tax Simplification

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

Present Law

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

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

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

Reasons for Change

The Committee believes that the overlap among the various anti-deferral regimes results in significant complexity, usually with little or no ultimate tax consequences. These overlaps require the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the various regimes.

Explanation of Provision

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

Effective Date

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

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

Present Law

Under the rules of subpart F (secs. 951-964), U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income and certain insurance income. Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). Under a de minimis rule, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $1 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income (sec. 954(b)(3)(A)).

Reasons for Change

The Committee believes that significant simplification can be achieved by expanding the subpart F de minimis rule.

Explanation of Provision

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

Effective Date

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

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

Present Law

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

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

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

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[32] In Rev. Rul. 71-141,[33] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations through

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

[33] 1971-1 C.B. 211.

their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distributed from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[34] In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, when adopting the 1997 final regulations, the IRS left uncertainty over whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

Reasons for Change

The Committee believes that a clarification is appropriate regarding the ability of a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership to claim a deemed-paid foreign tax credit.

Explanation of Provision

The provision clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. The provision also clarifies that both individual and corporate partners may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership.

Effective Date

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

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

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

Present Law

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

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

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

The earnings and profits surplus or deficit of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations. However, Treas. Prop. Reg. sec. 1.964-1(c)(1)(ii)(B) provides that, for purposes of computing a foreign corporation's earnings and profits, the amount of expenses that must be capitalized into inventory under the uniform capitalization rules may not exceed the amount capitalized in keeping the taxpayer's books and records. For this purpose, the taxpayer's books and records must be prepared in accordance with U.S. generally accepted accounting principles for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates. This proposed regulation applies only for purposes of determining a foreign corporation's earnings and profits and does not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

Reasons for Change

The Committee believes that significant simplification can be achieved by limiting the circumstances in which foreign persons are required to apply the U.S. uniform capitalization rules.

Explanation of Provision

The provision provides that, in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale are capitalized using U.S. generally accepted accounting principles (i.e., the method used to ascertain income, profit, or loss for purposes of reports or statements to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes) for purposes of determining a U.S.-owned foreign corporation's earnings and profits and subpart F income. The uniform capitalization rules continue to apply to foreign corporations for purposes of determining income effectively connected with a U.S. trade or business and the related earnings and profits therefrom. Any change in the taxpayer's method of accounting required as a result of this provision is treated as a voluntary change initiated by the taxpayer and is deemed made with the consent of the Secretary of the Treasury (i.e., no application for change in method of accounting is required to be filed with the Secretary). Any resultant section 481(a) adjustment required to be taken into account is to be taken into account in the first year.

Effective Date

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

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

Present Law

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

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

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

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

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

Reasons for Change

The Committee observes that the secondary withholding tax with respect to dividends paid by certain foreign corporations has been largely superseded by the branch profits tax and applicable income tax treaties. Accordingly, the Committee believes that the tax should be repealed in the interest of simplification.

Explanation of Provision

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

Effective Date

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

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

Present Law

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

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller (sec. 865(a)). Thus, nonresident aliens generally are not taxable on capital gains because the gains generally are considered to be foreign-source income.[35]

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

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

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

An individual who is not a citizen and who spends 183 days or more in the United States during a calendar year generally would be treated as a U.S. resident under the substantial presence test of section 7701(b). Thus, in most cases, the individual who spends at least 183

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

days in the United States would not be subject to section 871(a)(2).[36] However, under the substantial presence test under section 7701(b), certain days of physical presence in the United States are not counted for purposes of meeting the 183-day rule. This includes days spent in the United States in which the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico; the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours; the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession; and certain exempt individuals. These exceptions from counting physical presence in the United States do not apply, however, for purposes of the special rule under section 871(a)(2). Thus, it is possible in certain cases for an individual to be present in the United States for at least 183 days without being treated as a U.S. resident under the substantial presence test of section 7701(b).[37]

Even if an individual spends at least 183 days in the United States but is not treated as a U.S. resident under section 7701(b), the nonresident individual's capital gains generally will be treated as foreign-source income and, thus, not subject to section 871(a)(2). In this regard, capital gains generally are from foreign sources if the individual is a nonresident, and from U.S. sources if the individual is a U.S. resident. Under a special rule, an individual is treated as a U.S. resident for sales of personal property (including sales giving rise to capital gains) if the individual has a tax home in the United States. This rule applies even if the individual is treated as a nonresident for other U.S. tax purposes. An individual's capital gains would be treated as U.S.-source income and potentially subject to section 871(a)(2) if the individual is treated as a U.S. resident under this special rule.[38]

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

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

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

Even in the limited cases in which the special rule under section 871(a)(2) could potentially apply, a tax treaty might prevent its application.[39]

Reasons for Change

The Committee observes that the special tax on certain capital gains of nonresident aliens applies only under a very limited set of circumstances as a practical matter. The Committee believes that the special tax creates unnecessary complexity and confusion and thus should be repealed.

Explanation of Provision

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

Effective Date

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

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or business, or if the sale qualifies for the exception from U.S.-source treatment as a result of a material participation in the sale by a foreign office of the taxpayer.

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

C. Additional International Tax Provisions

1. Subpart F exception for active aircraft and vessel leasing income (sec. 221 of the bill and sec. 954 of the Code)

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include currently in income for U.S. tax purposes certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries.

In addition, foreign base company shipping income includes dividends and interest that a controlled foreign corporation receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a controlled foreign corporation's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation. Under a coordination rule, income that is treated as foreign base company shipping income of a corporation is not treated as any other type of foreign base company income of such corporation for purposes of subpart F.

Subpart F income also includes foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Reasons for Change

The Committee believes that the income earned by a controlled foreign corporation in connection with an active foreign aircraft or ship leasing business should be excluded from the anti-deferral rules of subpart F, provided that the controlled foreign corporation conducts substantial activities with respect to such business.

Explanation of Provision

The provision provides that "qualified leasing income" derived from or in connection with the leasing or rental of any aircraft or vessel is not treated as foreign personal holding company income or foreign base company shipping income of a controlled foreign corporation. The provision defines "qualified leasing income" as rents or gains derived in the active conduct of a leasing trade or business with respect to which the controlled foreign corporation conducts substantial activity, provided that the leased property is used by the lessee or other end-user in foreign commerce and predominantly outside the United States, and such lessee or other end-user is not related to the controlled foreign corporation (within the meaning of sec. 954(d)(3)).

In determining whether an aircraft or vessel is used in foreign commerce, the Committee intends that foreign commerce encompass the use of an aircraft or vessel in the transportation of property or passengers: (1) between an airport or port in the United States (including for this purpose any possession of the United States) and an airport or port in a foreign country; (2) between an airport or port in a foreign country and another in the same country; or (3) between an airport or port in a foreign country and another in a different foreign country. The Committee intends that an aircraft or vessel be considered as used predominantly outside the United States if more than 70 percent of its miles traveled during the taxable year are traveled outside the United States, or if the aircraft or vessel is located outside the United States for more than 70 percent of the time during the taxable year.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 222 of the bill and sec. 954 of the Code)

Present Law

In general, the rules of subpart F (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include certain income of the controlled foreign corporation (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

Reasons for Change

The Committee believes that present law unduly restricts the ability of U.S.-based multinational corporations to move their active foreign earnings from one controlled foreign corporation to another. In many cases, taxpayers are able to circumvent these restrictions as a practical matter, although at additional transaction cost. The Committee believes that taxpayers should be given greater flexibility to move non-subpart-F earnings among controlled foreign corporations as business needs may dictate.

Explanation of Provision

Under the provision, dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation are not treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. For these purposes, a related controlled foreign corporation is a controlled foreign corporation that controls or is controlled by the other controlled foreign corporation, or a controlled foreign corporation that is controlled by the same person or persons that control the other controlled foreign corporation. Ownership of more than 50 percent of the controlled foreign corporation's stock (by vote or value) constitutes control for these purposes.

Effective Date

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

3. Look-through treatment under subpart F for sales of partnership interests (sec. 223 of the bill and sec. 954 of the Code)

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends. Thus, if a controlled foreign corporation sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the controlled foreign corporation as subpart F income.

Reasons for Change

The Committee believes that the sale of a partnership interest by a controlled foreign corporation that owns a significant interest in the partnership should constitute subpart F income only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

Explanation of Provision

The provision treats the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly, indirectly, or constructively at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a controlled foreign corporation that meets this ownership threshold constitutes subpart F income under the proposal only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income. The Treasury Secretary is directed to prescribe such regulations as may be appropriate to prevent the abuse of this provision.

Effective Date

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

4. Election not to use average exchange rate for foreign tax paid other than in functional currency (sec. 224 of the bill and sec. 986 of the Code)

Present Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.[40] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[41]

Reasons for Change

The Committee believes that taxpayers generally should be permitted to elect whether to translate foreign income tax payments using an average exchange rate for the taxable year or the exchange rate in effect when the taxes are paid, provided such election does not provide opportunities for abuse.

Explanation of Provision

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the provision provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[42] Any election under the provision applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The

[40] Sec. 986(a)(1).

[41] Sec. 986(a)(2).

[42] Electing taxpayers translate foreign income tax payments pursuant to the same present-law rules that apply to taxpayers that are required to translate foreign income taxes using the exchange rates as of the time such taxes are paid.

provision authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 2004.

5. Foreign tax credit treatment of "base difference" items (sec. 225 of the bill and sec. 904 of the Code)

Present Law

In order to mitigate the possibility of double taxation of cross-border income, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[43] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) ("general limitation" income).

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[44] In cases in which foreign law imposes tax on an item of income that does not constitute income under U.S. tax principles (a "base difference" item), the tax is treated as imposed on income in the general limitation category.[45]

[43] Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits).

[44] Treas. Reg. sec. 1.904-6.

[45] Treas. Reg. sec. 1.904-6(a)(1)(iv).

Reasons for Change

The Committee believes that the existing Treasury regulation addressing "base differences" reaches appropriate results with respect to most taxpayers. However, taxpayers in the financial services industry may have little or no income in the general limitation category because the bulk or all of their business income falls within the financial services income category. As applied to such taxpayers, the regulation has the result of assigning taxes attributable to base differences to a limitation category in which the taxpayer may earn little or no income, thus rendering it unduly difficult for such a taxpayer to claim a credit for such foreign taxes. The Committee believes that taxpayers should be allowed to make a one-time election to treat taxes on "base difference" items as being imposed either on general limitation income or on financial services income. The Committee further expects that the Secretary will reexamine the "base difference" regulation to determine whether the regulation reaches appropriate results in other circumstances.

Explanation of Provision

Under the provision, creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed either on general limitation income or on financial services income, at the taxpayer's election. Once made, this election applies to all such taxes and is revocable only with the consent of the Secretary.

Effective Date

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

6. Modification of exceptions under subpart F for active financing (sec. 226 of the bill and sec. 954 of the Code)

Present Law

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called “active financing income”).[46]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain

[46] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (P.L. No. 107-147) extended the temporary exceptions for five years, applicable only for taxable years beginning after 2001 and before 2007, with a modification relating to insurance reserves.

CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Reasons for Change

The Committee understands that banking and financial regulatory requirements in many foreign countries require different financial services activities to be conducted in separate entities, and that the interaction of these requirements with the present-law rules regarding active financing income often require financial services firms to operate inefficiently. The Committee believes that the rules for determining whether a CFC or QBU is eligible to earn active financing income should be more consistent with the rules for determining whether income earned by an eligible CFC or QBU is active financing income. In particular, the Committee believes that activities performed by employees of certain affiliates of a CFC or QBU should be taken into account in determining whether income of the CFC or QBU is active financing income in a manner similar to the present-law rules for determining whether the CFC or QBU is eligible to earn active financing income.

Explanation of Provision

The provision modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the provision provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country. For purposes of determining whether a CFC or QBU is eligible to earn active financing income, such activity may not be taken into account by any CFC or QBU (including the employer of the employees performing the activity) other than the CFC or QBU for which the activities are performed.

Effective Date

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

7. United States property not to include certain assets of controlled foreign corporation (sec. 227 of the bill and sec. 956 of the Code)

Present Law

In general, the subpart F rules[47] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year.[48]

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[49] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[50] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[51]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a

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[47] Secs. 951-964.

[48] Sec. 951(a)(1)(B).

[49] Sec. 956(a).

[50] Secs. 956 and 959.

[51] Secs. 951(a)(1)(B) and 959.

secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[52]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[53]

Reasons for Change

The Committee believes that the acquisition of securities by a controlled foreign corporation in the ordinary course of its business as a securities dealer generally should not give rise to an income inclusion as an investment in U.S. property under the provisions of subpart F. Similarly, the Committee believes that the acquisition by a controlled foreign corporation of obligations issued by unrelated U.S. noncorporate persons generally should not give rise to an income inclusion as an investment in U.S. property.

Explanation of Provision

The provision adds two new exceptions from the definition of U.S. property for determining current income inclusion by a U.S. 10-percent shareholder with respect to an investment in U.S. property by a controlled foreign corporation.

The first exception generally applies to securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a dealer in securities. The exception applies only if the controlled foreign corporation dealer: (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

[52] Sec. 956(c)(1).

[53] Sec. 956(c)(2).

The second exception generally applies to the acquisition by a controlled foreign corporation of obligations issued by a U.S. person that is not a domestic corporation and that is not (1) a U.S. 10-percent shareholder of the controlled foreign corporation, or (2) a partnership, estate or trust in which the controlled foreign corporation or any related person is a partner, beneficiary or trustee immediately after the acquisition by the controlled foreign corporation of such obligation.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

8. Provide equal treatment for interest paid by foreign partnerships and foreign corporations (sec. 228 of the bill and sec. 861 of the Code)

Present Law

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[54] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[55] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[56]

Reasons for Change

The Committee believes that the source of interest income received from a foreign partnership or foreign corporation should be consistent. The Committee believes that interest payments from a foreign partnership engaged in a trade or business in the United States should be sourced in the same manner as interest payments from a foreign corporation engaged in a trade or business in the United States.

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[54] Sec. 861(a)(1).

[55] Treas. Reg. sec. 1.861-2(a)(2).

[56] Sec. 884(f)(1).

Explanation of Provision

The provision treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The provision applies only to foreign partnerships that are principally owned by foreign persons. For this purpose, a foreign partnership is principally owned by foreign persons if, in the aggregate, U.S. citizens and residents do not own, directly or indirectly, 20 percent or more of the capital or profits interests in the partnership.

Effective Date

This provision is effective for taxable years beginning after December 31, 2003.

9. Foreign tax credit treatment of deemed payments under section 367(d) (sec. 229 of the bill and sec. 367 of the Code)

Present Law

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[57]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[58] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category

[57] Secs. 865(d), 862(a).

[58] Sec. 904(d).

(under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[59]

Reasons for Change

The Committee believes that it is appropriate to characterize deemed payments under section 367(d) as royalties for purposes of applying the separate limitation categories of the foreign tax credit, and that this treatment should be effective for all transactions subject to the underlying provision of the 1997 Act.

Explanation of Provision

The provision specifies that deemed payments under section 367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit.

Effective Date

The provision is effective for amounts treated as received on or after August 5, 1997 (the effective date of the relevant provision of the 1997 Act).

10. Modify FIRPTA rules for real estate investment trusts (sec. 230 of the bill and secs. 857 and 897 of the Code)

Present Law

A real estate investment trust ("REIT") is a U.S. entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT, and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income to its investors before the end of its taxable year.

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property, including certain transactions involving REITs. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA").

In general, FIRPTA provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a U.S. trade or business during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real

[59] Sec. 904(d)(3).

property interest at the same rates that apply to similar income received by U.S. persons. For these purposes, the receipt of a distribution from a REIT is treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT. These capital gains distributions from REITs generally are subject to withholding tax at a rate of 35 percent (or a lower treaty rate). In addition, the recipients of these capital gains distributions are required to file Federal income tax returns in the United States, since the recipients are treated as earning income effectively connected with a U.S. trade or business.

In addition, foreign corporations that have effectively connected income generally are subject to the branch profits tax at a 30-percent rate (or a lower treaty rate).

Reasons for Change

The Committee believes that it is appropriate to provide greater conformity in the tax consequences of REIT distributions and other corporate stock distributions.

Explanation of Provision

The provision removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT, provided that (1) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the United States and (2) the foreign investor does not own more than 5 percent of the class of stock at any time during the taxable year within which the distribution is received.

Thus, a foreign investor is not required to file a U.S. Federal income tax return by reason of receiving such a distribution. The distribution is to be treated as a REIT dividend to that investor, taxed as a REIT dividend that is not a capital gain. Also, the branch profits tax no longer applies to such a distribution.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

11. Temporary rate reduction for certain dividends received from controlled foreign corporations (sec. 231 of the bill and new sec. 965 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[60] and the passive foreign investment company rules.[61] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[62]

Reasons for Change

The Committee observes that the residual U.S. tax imposed on the repatriation of lower-tax foreign earnings serves as a disincentive to repatriate such earnings. The Committee does not believe that this disincentive is objectionable as a general matter, as it is inherent in the design of the U.S. deferral-based tax system, under which U.S.-based multinational corporations enjoy a significant timing benefit with respect to most active foreign earnings relative to comparable domestic earnings. Nevertheless, the Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained offshore. The Committee emphasizes that this is a temporary economic stimulus measure. The Committee does not intend to make this measure permanent, or to "extend" or enact it again in the future.

Explanation of Provision

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

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[63] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

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

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[60] Secs. 951-964.

[61] Secs. 1291-1298.

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

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

development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation."

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

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

Effective Date

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

12. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals (sec. 232 of the bill and sec. 872 of the Code)

Present Law

Under section 871, certain items of gross income received by a nonresident alien from sources within the United States are subject to a flat 30-percent withholding tax. Gambling winnings received by a nonresident alien from wagers placed in the United States are U.S.-source and thus generally are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S.-source gambling winnings of residents of the other treaty country from U.S. withholding tax. In addition, no withholding tax is imposed under section 871 on the non-business gambling income of a nonresident alien from wagers on the following games (except to the extent that the Secretary determines that collection of the tax would be administratively feasible): blackjack, baccarat, craps, roulette, and big-6 wheel. Various other (non-gambling-related) items of income of a nonresident alien are excluded from gross income under section 872(b) and are thereby exempt from the 30-percent withholding tax, without any authority for the Secretary to impose the tax by regulation. In cases in which a withholding tax on gambling winnings applies, section 1441(a) of the Code requires the party making the winning payout to withhold the appropriate amount and makes that party responsible for amounts not withheld.

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[64] event taking place within the United States, the

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[64] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in

source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

Reasons for Change

The Committee believes that nonresident aliens should be able to wager outside the United States in pari-mutuel pools on live horse or dog races taking place within the United States without any resulting winnings being subjected to U.S. income tax, regardless of whether the foreign pool is merged with a U.S. pool.

Explanation of Provision

The provision provides an exclusion from gross income under section 872(b) for winnings paid to a nonresident alien resulting from a legal wager initiated outside the United States in a pari-mutuel pool on a live horse or dog race in the United States, regardless of whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Effective Date

The provision is effective for wagers made after the date of enactment of the provision.

13. Limitation of withholding on U.S.-source dividends paid to Puerto Rico corporation (sec. 233 of the bill and secs. 881 and 1442 of the Code)

Present Law

In general, dividends paid by corporations organized in the United States[65] to corporations organized outside of the United States and its possessions are subject to U.S. income tax withholding at the flat rate of 30 percent. The rate may be reduced or eliminated under a tax treaty. Dividends paid by U.S. corporations to corporations organized in certain U.S.

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which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

[65] The term "United States" does not include its possessions. Sec. 7701(a)(9).

possessions are subject to different rules.[66] Corporations organized in the U.S. possessions of the Virgin Islands, Guam, American Samoa or the Northern Mariana Islands are not subject to withholding tax on dividends from corporations organized in the United States, provided that certain local ownership and activity requirements are met. Each of those possessions have adopted local internal revenue codes that provide a zero rate of withholding tax on dividends paid by corporations organized in the possession to corporations organized in the United States.

Under the tax laws of Puerto Rico, which is also a U.S. possession, a 10 percent withholding tax is imposed on dividends paid by Puerto Rico corporations to non-Puerto Rico corporations.[67] Dividends paid by corporations organized in the United States to Puerto Rico corporations are subject to U.S. withholding tax at a 30 percent rate. Under Puerto Rico law, Puerto Rico corporations may elect to credit their U.S. income taxes against their Puerto Rico income taxes. Creditable income taxes include the 30 percent dividend withholding tax and the underlying U.S. corporate tax attributable to the dividends. However, a Puerto Rico corporation's tax credit for U.S. income taxes may be limited because the sum of the U.S. withholding tax and the underlying U.S. corporate tax generally exceeds the amount of Puerto Rico corporate income tax imposed on the dividend. Consequently, Puerto Rico corporations with subsidiaries organized in the United States may be subject to some degree of double taxation on their U.S. subsidiaries' earnings.

Reasons for Change

The 30 percent withholding tax rate on U.S.-source dividends to Puerto Rico corporations places such companies at an economic disadvantage relative to corporations organized in foreign countries with which the United States has a tax treaty, and relative to corporations organized in other possessions. The Committee believes that creating and maintaining parity between U.S. and Puerto Rico dividend withholding tax rates would place Puerto Rico corporations on a more level playing field with corporations organized in treaty countries and other possessions.

Explanation of Provision

The provision lowers the withholding income tax rate on U.S. source dividends paid to a corporation created or organized in Puerto Rico from 30 percent to 10 percent, to create parity with the 10 percent withholding tax imposed by Puerto Rico on dividends paid to non-Puerto Rico corporations. The lower rate applies only if the same local ownership and activity requirements are met that are applicable to corporations organized in other possessions receiving dividends from corporations organized in the United States. The Committee believes that it is

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[66] The usual method of effecting a mitigation of the flat 30 percent rate - an income tax treaty providing for a lower rate - is not possible in the case of a possession. *See* S. Rep. No. 1707, 89th Cong., 2d Sess. 34 (1966).

[67] The 10 percent withholding rate may be subject to exemption or elimination if the dividend is paid out of income that is subject to certain tax incentives offered by Puerto Rico. These tax incentives may also reduce the rate of underlying Puerto Rico corporate tax to a flat rate of between two and seven percent.

desirable that the U.S. and Puerto Rico corporate dividend withholding tax rates should remain in parity in the future. Accordingly, the Committee intends to revisit the U.S. dividend withholding tax rate should there be a change to the relevant Puerto Rico rate.

Effective Date

The provision is effective for dividends paid after date of enactment.

14. Require Commerce Department report on adverse decisions of the World Trade Organization (sec. 234 of the bill)

Present Law

The Secretary of Commerce does not have an obligation to transmit any future report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means, in consultation with the United States Trade Representative, regarding whether dispute settlement panels or the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, or safeguard measures not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, or the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

Reasons for Change

The Committee believes it is important to be informed of decisions by dispute settlement panels and the Appellate Body of the World Trade Organization.

Explanation of Provision

The provision requires that by no later than March 31, 2004, the Secretary of Commerce, in consultation with the United States Trade Representative, shall transmit a report to the Senate Committee on Finance and the House of Representatives Committee on Ways and Means regarding whether dispute settlement panels or the Appellate Body of the World Trade Organization have (1) added to or diminished the rights of the United States by imposing obligations and restrictions on the use of antidumping, countervailing, or safeguard measures not agreed to under the World Trade Organization Antidumping Agreement, the Agreement on Subsidies and Countervailing Measures, or the Agreement on Safeguards; (2) appropriately applied the standard of review contained in Article 17.6 of the Antidumping Agreement; or (3) exceeded its authority or terms of reference.

Effective Date

The provision is effective on the date of enactment.

15. Study of impact of international tax law on taxpayers other than large corporations (sec. 235 of the bill)

Present Law

The United States employs a "worldwide" tax system, under which U.S. persons (including domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including foreign corporations) are subject to U.S. tax only on U.S.-source income and income that has a sufficient nexus to the United States. The United States generally provides a credit to U.S. persons for foreign income taxes paid or accrued.[68] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[69]

Within this basic framework, there are a variety of rules that affect the U.S. taxation of cross-border transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S.-source income. Such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign-source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deductions between related persons in order to ensure the clear reflection of the income of each person and to prevent the avoidance of tax. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on certain income from foreign operations of certain U.S.-owned foreign corporations.

A cross-border transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and mitigate the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

Reasons for Change

The Committee understands that the international tax rules may create disproportionate compliance costs for taxpayers that are not large corporations. The Committee believes that the Treasury Secretary (or his delegate) should study these taxpayers' compliance burden in this regard and provide recommendations to reduce this burden.

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[68] Sec. 901.

[69] Secs. 901, 904.

Explanation of Provision

The provision requires the Secretary of the Treasury or the Secretary's delegate to conduct a study of the impact of Federal international tax rules on taxpayers other than large corporations, including the burdens placed on such taxpayers in complying with such rules. In addition, not later than 180 days after the date of the enactment of this provision, the Secretary shall report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives the results of the study conducted as a result of this provision, including any recommendations for legislative or administrative changes to reduce the compliance burden on taxpayers other than large corporations and for such other purposes as the Secretary determines appropriate.

Effective Date

The provision is effective on the date of enactment.

16. Consultative role for Senate Committee on Finance in connection with the review of proposed tax treaties (sec. 236 of the bill)

Present Law

The United States maintains a network of bilateral tax treaties that limit the amount of tax that may be imposed by one treaty country on residents of the other treaty country. Most of these treaties are income tax treaties designed to reduce or eliminate the double taxation of income earned by residents of either country from sources within the other country, and to prevent the avoidance or evasion of the taxes of the two countries.

Under the Constitution, treaties become effective only upon the advice and consent of the Senate. After a proposed tax treaty is signed and formally transmitted by the President to the Senate, the Senate Committee on Foreign Relations reviews the proposed treaty, conducts ratification hearings, and reports to the Senate with a recommendation as to ratification of the proposed treaty. The Senate Committee on Finance has no formal role in the process.

Reason for Change

The Committee believes that the Senate Committee on Finance should have a consultative role with respect to proposed tax treaties received and reported by the Senate Committee on Foreign Relations.

Explanation of Provision

Under the provision, the Senate Committee on Foreign Relations would be required to consult with the Senate Committee on Finance with respect to proposed tax treaties prior to reporting any such treaty to the Senate. The Senate Committee on Finance would be required to respond in writing within 120 days of receipt of a request for consultation from the Senate Committee on Foreign Relations. If the Senate Committee on Finance does not respond within this time period, the Committee will be considered to have waived the right to consult with respect to the provisions of the tax treaty.

The Senate Committee on Foreign Relations would be required to consider the views of the Senate Committee on Finance when reporting a tax treaty to the Senate and would be required to include the views of the Senate Committee on Finance in its report to the Senate.

Effective Date

The provision would be effective on the date of enactment.

TITLE III - DOMESTIC MANUFACTURING AND BUSINESS PROVISIONS

A. Domestic Manufacturing and Business Provisions

1. Expansion of qualified small-issue bond program (sec. 301 of the bill and sec. 144 of the Code)

Present Law

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the limit. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located. No more than $250,000 per borrower ($62,500 for used property) may be used to finance eligible farm property.

Property and businesses eligible for this financing are specified. For example, only depreciable property (and related real property) used in the production of tangible personal property is eligible for financing as a manufacturing facility. Storage and distribution of products generally is not treated as production under this provision. Agricultural land and equipment may only be financed for first-time farmers, defined as individuals who have not at any prior time owned farmland in excess of (1) 30 percent of the median size of a farm in the same county or (2) $125,000 in value.

Before 1987, qualified small-issue bonds also could be used to finance commercial facilities. In addition to general prohibitions on the tax-exempt private activity bond financing of certain facilities, Federal law precludes the use of qualified small-issue bonds to finance a broader list of facilities. For example, no more than 25 percent of a bond issue can be used to finance restaurants, bars, automobile sales and service facilities, or entertainment facilities. No portion of these bond proceeds can be used to finance golf courses, country clubs, massage parlors, tennis clubs or other racquet sport facilities, skating facilities, hot tub facilities, or racetracks.

Reasons for Change

The Committee believes that the class of facilities eligible for qualified small-issue bond financing should be expanded to include otherwise eligible facilities with total capital expenditures of less than $20 million. The present-law capital expenditures limit of $10 million has not been adjusted in many years.

Explanation of Provision

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

Effective Date

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

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

Present Law

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

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Rev. Proc. 87-56, 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

Reasons for Change

The Committee believes it is important to continue to build the nation's internet infrastructure as these technologies, and the network they create, provide the basis of future income and job growth. In particular, development of this infrastructure in underserved and rural areas is critical to future job and income growth in these areas. In addition, the Committee believes that the economy's current recovery can be enhanced by providing a short-term stimulus to such investments.

Explanation of Provision

The bill provides that the taxpayer may elect to treat qualified broadband expenditures paid or incurred after December 31, 2003, and before January 1, 2005, as a deduction in the taxable year in which the equipment is placed in service.

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

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

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

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

Effective Date

The proposal is effective for expenditures incurred after December 31, 2003.

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

Present Law

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

Special rules apply for the allocation of interest expense to property produced by the taxpayer.[70] In general, interest paid or incurred during the production period of certain types of property that is allocable to the production of the property must be capitalized. Property subject to the interest capitalization requirement includes property produced by the taxpayer for use in its trade or business or in an activity for profit, but only if it (1) is real property, (2) has an estimated production period exceeding two years (one year if the cost of the property exceeds $1 million), or (3) has a class life of 20 years or more (as defined under section 168). The production period of property for this purpose begins when construction or production is commenced and ends when the property is ready to be placed in service or is ready to be held for sale. For example, in the case of property such as tobacco, wine, or whiskey that is aged before it is sold, the production period includes the aging period. Activities such as planning or design generally do not cause the production period to begin.

Reasons for Change

The Committee is concerned about an inequity in the Code that results in capitalization of a portion of a taxpayer's interest expense for certain distilled spirits merely due to the natural aging process of such product (e.g., fine bourbon). The requirement to capitalize such costs results in a competitive disadvantage for such distillers compared to other distilled products in which natural aging is not required (e.g., vodka). This provision removes this inequity and will aid many small distilleries located in the United States by not forcing them to carry additional inventory costs over long periods of time.

[70] Sec. 263A(f).

Explanation of Provision

The provision provides that for purposes of determining the production period for purposes of capitalization of interest expense under section 263A(f) that the production period for distilled spirits shall be determined without regard to any period allocated to the natural aging process.[71]

Effective Date

The provision applies to production periods beginning after the date of enactment.

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

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[72] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[73]

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[74] However, if the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the

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

[72] Section 355(b).

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

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

corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[75]

Reasons for Change

Prior to a spin-off under section 355 of the Code, corporate groups that have conducted business in separate corporate entities often must undergo elaborate restructurings to place active businesses in the proper entities to satisfy the 5-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the requirements regarding the activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business.

The Committee believes that it is appropriate to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355.

Explanation of Provision

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

Effective Date

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

The bill also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[76]

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

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

5. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness (sec. 305 of the bill and sec. 514 of the Code)

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes. Certain types of income, such as rents, royalties, dividends, and interest, generally are excluded from unrelated business taxable income except when such income is derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.[77] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property. An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is not treated as the creation of a new indebtedness.

Reasons for Change

Small business investment companies obtain financial assistance from the Small Business Administration in the form of equity or by incurring indebtedness that is held or guaranteed by the Small Business Administration pursuant to the Small Business Investment Act of 1958. Tax-exempt organizations that invest in small business investment companies who are treated as partnerships and who incur indebtedness that is held or guaranteed by the Small Business Administration may be subject to unrelated business income tax on their distributive shares of income from the small business investment company. The Committee believes that the imposition of unrelated business income tax in such cases creates a disincentive for tax-exempt organizations to invest in small business investment companies, thereby reducing the amount of

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of a restructuring that occurs after the date of enactment and that would satisfy the requirements of new section 355(b)(2)(A).

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

investment capital that may be provided by small business investment companies to the nation's small businesses.

Explanation of Provision

The provision modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act, and (2) held or guaranteed by the Small Business Administration.

Effective Date

The provision is effective for debt incurred by a small business investment company after December 31, 2003, with respect to property it acquires after such date.

6. Modified taxation of imported archery products (sec. 306 of the bill and sec. 4161 of the Code)

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.[78] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[79] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[80]

Reasons for Change

Under present law, foreign manufacturers and importers of arrows avoid the 12.4 percent excise tax paid by domestic manufacturers because the tax is placed on arrow components rather than finished arrows. As a result, arrows assembled outside of the United States have a price advantage over domestically manufactured arrows. The Committee believes it is appropriate to close this loophole. The Committee also believes that adjusting the minimum draw weight for taxable bows from 10 pounds to 30 pounds will better target the excise tax to actual hunting use by eliminating the excise tax on instructional ("youth") bows.

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

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

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

Explanation of Provision

The bill increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[81] The bill also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the bill. In the case of any arrow comprised of a shaft or any other component upon which tax has been imposed, the amount of the arrow tax is equal to the excess of (1) the arrow tax that would have been imposed but for this exception, over (2) the amount of tax paid with respect to such components. Finally, the bill subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

7. Modification to cooperative marketing rules to include value added processing involving animals (sec. 307 of the bill and sec. 1388 of the Code)

Present Law

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

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

Reasons for Change

The Committee disagrees with the apparent IRS position concerning the marketing of certain products by cooperatives after the cooperative has added value to the products through

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

the use of animals. Therefore, the Committee believes that the tax rules should be modified to clarify that cooperatives are permitted to market such products.

Explanation of Provision

The provision provides that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

Effective Date

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

8. Extension of declaratory judgment procedures to farmers' cooperative organizations (sec. 308 of the bill and sec. 7428 of the Code)

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[82] In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

Reasons for Change

The Committee believes that declaratory judgment procedures currently available to other organizations and in other situations also should be available to farmers' cooperative

[82] For disputes involving the initial or continuing qualification of an organization described in sections 501(c)(3), 509(a), or 4942(j)(3), declaratory judgment actions may be brought in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. For all other Federal tax declaratory judgment actions, proceedings may be brought only in the U.S. Tax Court.

organizations with respect to an IRS determination regarding the status of an organization as a farmers' cooperative under section 521.

Explanation of Provision

The provision extends the declaratory judgment procedures to cooperatives. Such a case may be commenced in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and such court would have jurisdiction to determine a cooperative's initial or continuing qualification as a farmers' cooperative described in section 521.

Effective Date

The provision is effective for pleadings filed after the date of enactment.

9. Temporary suspension of personal holding company tax (sec. 309 of the bill and sec. 541 of the Code)

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Table 1.–Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0 - $50,000	15 percent of taxable income
$50,001 - $75,000	25 percent of taxable income
$75,001 - $10,000,000	34 percent of taxable income
Over $10,000,000................................	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333.

When a corporation distributes its after-tax earnings to individual shareholders as dividends, a tax is imposed on the shareholders at rates up to 15 percent.[83] If a corporation receives a dividend from another corporation, the recipient corporation is entitled to a dividends-received deduction that excludes a significant part of the dividend from the recipient's income. The percentage of a dividend received that is deducted varies from 70 percent to 100 percent,

[83] The 15-percent rate applies to dividends received in taxable years beginning before January 1, 2009. Dividends received on or after that date are scheduled to be taxed at the rates applicable to ordinary income, which range up to 35 percent (39.6 percent for taxable years beginning after December 31, 2010).

depending on the level of ownership of the recipient corporation in the distributing corporation.[84] Thus, with a 70 percent dividends received deduction, the tax rate imposed on a dividend received by a corporation in the 35-percent tax bracket is 10.5 percent.[85] For corporations at lower rate brackets, the tax rates on these dividends are lower.

In addition to the regular corporate income tax, a corporate level penalty tax, the "personal holding company tax" is currently imposed at 15 percent [86] on certain corporate earnings of personal holding companies that are not distributed to shareholders. The personal holding company tax was originally enacted to prevent so-called "incorporated pocketbooks" that could be formed by individuals to hold assets that could have been held directly by the individuals, such as passive investment assets, and retain the income at corporate rates that were then significantly lower than individual tax rates.

Corporations are personal holding companies only if they are closely held and have substantial passive income. A corporation is closely held if, at any time during the last half of the taxable year, more than 50 percent of the value of the stock of the corporation is owned, directly or indirectly, by five or fewer individuals (determined with the application of specified attribution rules). A corporation has substantial passive income if at least 60 percent of the corporation's adjusted ordinary gross income (as defined for this purpose) is "personal holding company income," generally, income from interest, dividends, rents, royalties, compensation for use of corporate property by certain shareholders, and income under contracts giving someone other than the corporation the right to designate the individual service provider. Numerous adjustments apply in specified situations where there are specified indicia that the income is active rather than passive.

A corporation that otherwise would be subject to personal holding company tax can distribute, or can agree to be deemed to have distributed, its modified taxable income and avoid the tax. A corporation may make such an actual dividend distribution during its taxable year or, up to a specified limited amount, until the 15th day of the third month following the close of its taxable year. In addition, if an election is filed with its return for the year, its shareholders may agree to include a deemed amount in their income as if a dividend had been paid ("consent dividend"). A corporation may also make a "deficiency dividend" distribution within 90 days following a determination by the IRS or a court that personal holding company tax liability is

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[84] If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns 80 percent or more of the distributing corporation, the dividends received deduction is generally 100 percent.

[85] This is the 35 percent tax rate, applied to the 30 percent of the dividend that is taxable after a 70 percent dividends-received deduction.

[86] This rate is scheduled to return to the highest individual tax rate when the lower dividend tax rate expires.

due. That distribution can eliminate the personal holding company tax itself, though interest (and penalties, if any) with respect to such tax would still be owed to the IRS.[87]

Reasons for Change

The personal holding company tax was enacted in 1934 to prevent individual shareholders from avoiding the steeply graduated income tax rates imposed on individuals at a time when the corporate tax rate was relatively low.

The Committee believes that today there is little incentive for taxpayers to use personal holding companies to avoid the individual income tax rates because the individual income tax rates are generally similar to, or lower than, the corporate income tax rates.

The Committee recognizes that, due to the dividends-received deduction, income from dividend paying stock is taxed more lightly when the dividend paying stock is held in a C corporation than when it is held by an individual. However, the differential between the maximum 10.5 percent rate on dividends received by a corporation and the maximum 15 percent rate on dividends received by individuals is relatively small. The committee does not expect that this differential will produce a significant incentive for individuals to hold such stocks in corporate entities.

Accordingly, the Committee believes that simplification can be achieved during the period that individual dividends are taxed at a maximum 15 percent rate, by repealing the personal holding company tax.

Explanation of Provision

The provision repeals the personal holding company tax until 2009, the period of time the 15 percent rate on dividends received by individuals is scheduled to be in effect.

Effective Date

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

The provision would be treated, for purposes of section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 as enacted by Title III of that Act (relating to lower rates on capital gains and dividends), so that the provision terminates when those provisions terminate (currently scheduled to be for taxable years beginning after December 31, 2008).

10. Increase section 179 expensing (sec. 310 of the bill and sec. 179 of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief

[87] Section 547.

Reconciliation Act (JGTRRA) of 2003[88] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[89] In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000.

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

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

<u>Reasons for Change</u>

The Committee believes that section 179 expensing provides two important benefits for small business. First, it lowers the cost of capital for qualifying property used in a trade or business. With a lower cost of capital, the Committee believes small business will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these benefits and to increase the number of eligible taxpayers, the Committee bill increases the capital investment allowed to be purchased under section 179 prior to the benefits being phased out.

<u>Explanation of Provision</u>

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

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[88] Pub. Law No. 108-27, sec. 202 (2003).

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

cost of qualifying property placed in service during the taxable year exceeds $400,000 ($200,000 for taxable years beginning 2006 and thereafter).[90]

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

Effective Date

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

11. Three-year carryback of net operating losses (sec. 311 of the bill and sec. 172 of the Code)

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[91] Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction).

Section 202 of the Job Creation and Worker Assistance Act of 2002[92] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two

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

[91] Sec. 172.

[92] Pub. Law No. 107-147.

years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.[93]

JCWAA also provided that an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, may offset 100 percent of a taxpayer's AMTI.

Reasons for Change

The NOL carryback and carryover rules are designed to allow taxpayers to smooth out swings in business income (and Federal income taxes thereon) that result from business cycle fluctuations and unexpected financial losses. The uncertain economic conditions that resulted in the enactment of the extended carryback of NOLs as part of the JCWAA have continued. As a consequence, many taxpayers continue to incur unexpected financial losses. Thus, the Committee believes a three-year NOL carryback period provides taxpayers in all sectors of the economy who are experiencing such losses the ability to increase their cash flow through the refund of income taxes paid in prior years, which can be used for capital investment or other expenses that will provide stimulus to the economy.

Explanation of Provision

The provision provides for a three-year carryback of NOLs for NOLs arising in taxable years ending in 2003.[94]

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[93] Because JCWAA was enacted after some taxpayers had filed tax returns for years affected by the provision, a technical correction is needed to provide for a period of time in which prior decisions regarding the NOL carryback may be reviewed. Similarly, a technical correction is needed to modify the carryback adjustment procedures of sec. 6411 for NOLs arising in 2001 and 2002. These issues were addressed in a letter dated April 15, 2002, sent by the Chairmen and Ranking Members of the House Ways and Means Committee and Senate Finance Committee, as well as in guidance issued by the IRS pursuant to the Congressional letter (Rev. Proc. 2002-40, 2002-23 I.R.B. 1096, June 10, 2002).

[94] Because certain taxpayers may have already filed tax returns (or be in the process of filing tax returns) for taxable years ending in 2003, the proposal contains special rules allowing taxpayers until April 15, 2004 to review prior decisions regarding an NOL carryback.

The provision also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2003 as well as NOL carryforwards to these taxable years, to offset 100 percent of a taxpayer's AMTI.

Effective Date

The three-year carryback provision is effective for net operating losses generated in taxable years ending in 2003. The provision relating to AMTI is effective for NOL carrybacks arising in, and NOL carryforwards to, taxable years ending in 2003.

B. Manufacturing Relating to Films

1. Special rules for certain film and television production (sec. 321 of the bill and new sec. 181 of the Code)

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Reasons for Change

The Committee understands that over the past decade, production of American film projects has moved to foreign locations. Specifically, in recent years, a number of foreign governments have offered tax and other incentives designed to entice production of U.S. motion pictures and television programs to their countries. These governments have recognized that the benefits of hosting such productions do not flow only to the film and television industry. These productions create broader economic effects, with revenues and jobs generated in a variety of other local businesses. Hotels, restaurants, catering companies, equipment rental facilities, transportation vendors, and many others benefit from these productions.

This has become a significant trend affecting the film and television industry as well as the small businesses that they support. The Committee understands that a recent report by the U.S. Department of Commerce estimated that runaway production drains as much as $10 billion per year from the U.S. economy. These losses have been most pronounced in made-for-television movies and miniseries productions. According to the report, out of the 308 U.S.-developed television movies produced in 1998, 139 were produced abroad. This is a significant increase from the 30 produced abroad in 1990.

The Committee believes the report makes a compelling case that runaway film and television production has eroded important segments of a vital American industry. According to official labor statistics, more than 270,000 jobs in the U.S. are directly involved in film production. By industry estimates, 70 to 80 percent of these workers are hired at the location where the production is filmed.

The Committee believes this legislation will encourage producers to bring feature film and television production projects to cities and towns across the United States, thereby decreasing the runaway production problem.

Explanation of Provision

The provision permits qualifying film and television productions to elect to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[95]

The provision limits the amount of production expenditures that may be expensed to $15 million for each qualifying production.[96] An additional $5 million of production expenditures may be deducted (up to $20 million in total) if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. Expenditures in excess of $15 million ($20 million in distressed areas) are required to be recovered over a three-year period using the straight-line method beginning in the month such property is placed in service.

The provision defines a qualified film or television production as any production of a motion picture (whether released theatrically or directly to video cassette or any other format); miniseries; scripted, dramatic television episode; or movie of the week if at least 75 percent of the total compensation expended on the production are for services performed in the United States.[97] With respect to property which is one or more episodes in a television series, only the first 44 episodes qualify under the proposal. Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

The provision also requires the Commerce Department to report on whether the provision materially aided in retaining film production in the U.S. The report is required to be submitted to the Senate Committee on Finance and the House Committee on Ways and Means no later than December 31, 2006.

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[95] An election to deduct such costs shall be made in such manner as prescribed by the Secretary and by the due date (including extensions of time) for filing the taxpayer's return of tax for the taxable year in which production costs of such property are first incurred. An election may not be revoked without the consent of the Secretary. The Committee intends that, in the absence of specific guidance by the Secretary, deducting qualifying costs on the appropriate tax return shall constitute a valid election.

[96] Thus, a qualifying film that is co-produced is limited to $15 million of deduction. The benefits of this provision shall be allocated among the owners of a film in a manner that reasonably reflects each owner's proportionate investment in and economic interest in the film.

[97] The term compensation does not include participations and residuals.

Effective Date

The provision is effective for qualifying productions started after the date of enactment and sunsets for qualifying productions commencing after December 31, 2008.

2. Modification of application of income forecast method of depreciation (sec. 322 of the bill and sec. 167 of the Code)

Present Law

Depreciation

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Income forecast method of depreciation

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

Reasons for Change

The Committee is aware that taxpayers and the IRS have expended significant resources in auditing and litigating disputes regarding the proper treatment of participations and residuals for purposes of computing depreciation under the income forecast method of depreciation. The Committee understands that these issues relate solely to the timing of deductions and not to whether such costs are valid deductions. In addition, the Committee is aware of other disagreements between taxpayers and the Treasury Department regarding the mechanics of the income forecast formula. The Committee believes expending taxpayer and government resources disputing these items is an unproductive use of economic resources. As such, the provision addresses the issues and eliminates any uncertainty as to the proper tax treatment of these items.

Explanation of Provision

The provision clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in section 167(g)(1)(A)). For purposes of the provision, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. The provision also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property.

The provision also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

In addition, the provision clarifies that, in the case of property eligible for the income forecast method that the holding in the *Associated Patentees*[98] decision will continue to constitute a valid method. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid as under the *Associated Patentees* decision. This may be done on a property-by-property basis and shall be applied consistently with respect to a given property

[98] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

thereafter. The provision also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective Date

The provision applies to property placed in service after date of enactment. No inference is intended as to the appropriate treatment under present law. It is intended that the Treasury Department and the IRS expedite the resolution of open cases. In resolving these cases in an expedited and balanced manner, the Treasury Department and IRS are encouraged to take into account the principles of the provision.

C. Manufacturing Relating to Timber

1. Expensing of reforestation expenses (sec. 331 of the bill and sec. 194 of the Code)

Present Law

Amortization of reforestation costs (sec. 194)

A taxpayer may elect to amortize up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Amortization is taken over 84 months (seven years) and is subject to a mandatory half-year convention. In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (i.e., an "above-the-line deduction") rather than as an itemized deduction.

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity. Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.

The amount amortized is reduced by one half of the amount of reforestation credit claimed under section 48(b) (see below). Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.

Reforestation tax credit (sec. 48(b))

A tax credit is allowed equal to 10 percent of the reforestation expenditures incurred during the year that are properly elected to be amortized. An amount allowed as a credit is subject to recapture if the qualifying timber property to which the expenditure relates is disposed of within five years.

Reasons for Change

The Committee believes it is important to encourage taxpayers to make investments in reforestation. The Committee believes that by shortening the recovery period of such outlays taxpayers will find a greater investment return to investments in reforestation. In addition, the Committee observes that elimination of the overlapping amortization and credit provisions of present law will simplify tax computation, record keeping, and tax return filing for taxpayers.[99]

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[99] The Committee notes that the staff of the Joint Committee on Taxation identified the overlap of amortization of reforestation expenses and the credit for reforestation expenses as an area of complexity and recommended that the overlapping provisions be replaced with expensing

Explanation of Provision

The bill permits taxpayers to elect to deduct (*i.e*., expense) up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Any expenses above $10,000 ($5,000) would be amortized over a seven-year period.

The provision replaces the credit provisions of present law.

Effective Date

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

2. Election to treat cutting of timber as a sale or exchange (sec. 332 of the bill and sec. 631(a) of the Code)

Present Law

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

Reasons for Change

The Committee believes that changes made in the tax law should allow a taxpayer to revoke its election to treat the cutting of timber as a sale or exchange.

Explanation of Provision

Under the provision, an election made for a taxable year ending on or before the date of enactment, to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.[100]

Effective Date

The provision is effective on date of enactment.

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of qualifying expenses. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Volume II, p. 463.

[100] The present-law rules of section 631(a) apply to any subsequent election.

3. Capital gains treatment to apply to outright sales of timber by landowner (sec. 333 of the bill and sec. 631(b) of the Code)

Present Law

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

Reasons for Change

The Committee believes that the requirement that the owner of timber retain an economic interest in the timber in order to obtain capital gain treatment under section 631(b) results in poor timber management. Under present law, the buyer, when cutting and removing timber, has no incentive to protect young or other uncut trees because the buyer only pays for the timber that is cut and removed. Therefore, the Committee bill eliminates this requirement and provides for capital gain treatment under section 631(b) in the case of outright sales of timber.

Explanation of Provision

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

Effective Date

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

4. Modified safe harbor rules for timber REITs (sec. 334 of the bill and sec. 857 of the Code)

Present Law

In general

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

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

Income or loss from prohibited transactions

A 100-percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business[101], other than foreclosure property.[102] A safe harbor is provided for certain sales of rent producing real property. To qualify for the safe harbor, three criteria generally must be met. First, the REIT must have held the property for at least four years for rental purposes. Second, the aggregate expenditures made by the REIT during the four-year period prior to the date of the sale must not exceed 30 percent of the net selling price of the property. Third, either (i) the REIT must make 7 or fewer sales of property during the taxable year or (ii) the aggregate adjusted basis of the property sold must not exceed 10 percent of the aggregate bases of all the REIT's assets at the beginning of the REIT's taxable year. In the latter case, substantially all of the marketing and development expenditures with respect to the property must be made through an independent contractor.

Certain timber income

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[103]

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than five percent of the total value of REIT assets

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

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

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

or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[104]

Special rules for Taxable REIT subsidiaries

Under an exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a REIT[105] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[106]

Reasons for Change

The Committee believes it is appropriate to provide a safe harbor from the prohibited transactions rules, to permit a REIT that holds timberland to make sales of timber property, provided there is not significant development of the property. A similar provision already exists for rental properties.

Explanation of Provision

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

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

(2) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of

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

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

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

the property (other than timberland acquisition expenditures[107]) and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;

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

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

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

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

Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (i.e., silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods, grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation

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

including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); (2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4) nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; and (7) initial stand fertilization, up through stand establishment. Other examples of capital expenditures incurred directly in the operation of raising timber include construction cost of road to be used for managing the timber land (including for removal of logs or fire protection), environmental costs (i.e., habitat conservation plans), and any other post stand establishment capital costs (e.g., "mid-term fertilization costs)."

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

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

Effective Date

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

TITLE IV - ADDITIONAL PROVISIONS

A. Provisions Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine (sec. 401 of the bill and sec. 7701 of the Code)

Present Law

In general

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

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[108]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[109]

Economic substance doctrine

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

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

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

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[110]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[111]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[112] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of *both* economic substance (i.e., the objective component) *and* business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[113] A narrower approach used by some courts is to conclude that either a business purpose *or* economic substance is sufficient to respect the transaction).[114] A third approach regards economic

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

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

[112] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

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

[114] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations

substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[115]

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory v. Helvering*,[116] several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[117] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[118] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[119] In these cases, in

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(the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test).") As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

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

[116] 293 U.S. 465 (1935).

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

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

[119] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v.*

assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Reasons for Change

The Committee is concerned that many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions.[120] These transactions usually produce surprising results that were not contemplated by Congress. Whether these transactions are respected usually hinges on whether the transaction had sufficient economic substance. The Committee is concerned that in addressing these transactions the courts, in some cases, are reaching conclusions inconsistent with Congressional intent. In addition, the Committee is concerned that in determining whether a transaction has economic substance, taxpayers are subject to different legal standards based on the circuit in which the taxpayer is located. Thus, the Committee believes it is appropriate to clarify for the courts the appropriate standards to use in determining whether a transaction has economic substance.

Explanation of Provision

In general

The provision clarifies and enhances the application of the economic substance doctrine. The provision provides that, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a

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Commissioner, 277 F.3d at 781 (applied the same test, *citing Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

[120] The Committee agrees with the famous statement of Judge Hand that "[a]nyone may so arrange his affairs that his taxes shall be as low as possible… ." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934). However, the Committee also agrees with the more recent statement of the court in *Saviano v. Commissioner*, 765 F.2d 643, 654 (7th Cir. 1985), which said:

> We have no quarrel with [Judge Hand's statement]; however, a caveat must be considered in conjunction with it. The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly. That is what we have done in this case and that is what taxpayers should expect in the future.

substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[121]

The provision does not change current law standards used by courts in determining when to utilize an economic substance analysis.[122] Also, the provision does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.[123] The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

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

Non-tax business purpose

The provision provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose

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

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

[123] *See, e.g., Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[124]

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[125] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[126] should not

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

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

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

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

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

be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[127]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[128]

Profit potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the provision merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[129] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

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

Transactions with tax-indifferent parties

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

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

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

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

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

Other rules

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

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

Effective Date

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

2. Penalty for failing to disclose reportable transaction (sec. 402 of the bill and sec. 6707A of the Code)

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[130]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[131] a transaction that is specified by the Treasury

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

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

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

Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[132]

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[133]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[134]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[135]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[136] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[137]

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

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

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

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

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

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

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[138]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[139]

Reasons for Change

The Committee is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax.[140] Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system.

The Committee over three years ago began working on legislation to address this significant compliance problem. In addition, the Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believes that additional legislation is needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

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

[139] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

[140] In this regard, the Committee has concerns with the outcomes and rationales used by courts in some recent decisions involving tax-motivated transactions. For a more detailed discussion of recent court decisions and other developments regarding tax shelters, *see* Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX 19-02), March 19, 2002.

Explanation of Provision

In general

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

Transactions to be disclosed

The provision does not define the terms "listed transaction"[141] or "reportable transaction," nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

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

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

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,[142] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The provision applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

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

3. Accuracy-related penalty for listed transactions and other reportable transactions having a significant tax avoidance purpose (sec. 403 of the bill and sec. 6662A of the Code)

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[143] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[144]

Special rules apply with respect to tax shelters.[145] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

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

[143] Sec. 6662.

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

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

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[146] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[147]

Reasons for Change

Because the Treasury shelter initiative emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but less stringent) accuracy-related penalty should apply to such transactions even when disclosed.

Explanation of Provision

In general

The provision modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[148] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

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[146] Sec. 6664(c).

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

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

Undisclosed transactions

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

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

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

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return)[149], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the

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

transaction in accordance with the regulations under section 6011,[150] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return that includes the item is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

<u>Disqualified tax advisor</u>

A disqualified tax advisor is any advisor who (1) is a material advisor[151] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[152] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of

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

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

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

the transaction with any federal, state or local government body.[153] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

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

Coordination with other penalties

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

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

Effective Date

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

4. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 404 of the bill and sec. 6662B of the Code)

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5)

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

any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[154] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[155] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[156] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[157]

Reasons for Change

The Committee is concerned that many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions. These transactions usually produce surprising results that were not contemplated by Congress. Whether these transactions are respected usually hinges on whether the transaction had sufficient economic substance. The Committee believes that the benefits that taxpayers potentially obtain from these transactions significantly outweigh the potential costs of engaging in such transactions. In addition, the Committee believes taxpayers will continue to engage in tax avoidance transactions until the risk and cost to the taxpayer of engaging in the transactions is increased. Thus, the Committee believes that taxpayers should be subject to the imposition of a substantial strict liability penalty for transactions that are determined not have economic substance.

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[154] Sec. 6662.

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

[156] Sec. 6664(c).

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

Explanation of Provision

The provision imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[158] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the provision (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier provision regarding the economic substance doctrine),[159] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier provision regarding the economic substance doctrine),[160] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this provision, the calculation of an "understatement" is made in the same manner as in the separate provision relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this provision would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[161] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after

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

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

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

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

the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

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

Prior to this penalty being asserted in the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals (e.g., a Revenue Agent Report), the IRS Chief Counsel or his delegate at the IRS National Office must approve the inclusion in writing. Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this provision and the reasons for the compromise.

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

Effective Date

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

5. Modifications of substantial understatement penalty for nonreportable transactions (sec. 405 of the bill and sec. 6662 of the Code)

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[162]

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

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[163]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[164]

Reasons for Change

The Committee believes that the present-law definition of substantial understatement allows large corporate taxpayers to avoid the accuracy-related penalty on questionable transactions of a significant size. The Committee believes that an understatement of more than $10 million is substantial in and of itself, regardless of the proportion it represents of the taxpayer's total tax liability.

The Committee believes that a higher compliance standard should be imposed on any taxpayer in order to reduce the amount of an understatement resulting from a transaction that the taxpayer did not adequately disclose. The Committee further believes that a taxpayer should not take a position on a tax return that could give rise to a substantial understatement penalty that the taxpayer does not believe is more likely than not the correct tax treatment unless this information is disclosed to the IRS.

Explanation of Provision

Definition of substantial understatement

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

Reduction of understatement for certain positions

The provision elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The provision also authorizes (but does not require) the Secretary to publish a list of

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

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

positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective Date

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

6. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 406 of the bill and sec. 7525 of the Code)

Present Law

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

Reasons for Change

The Committee believes that the rule currently applicable to corporate tax shelters should be applied to all tax shelters, regardless of whether or not the participant is a corporation.

Explanation of Provision

The provision modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

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

7. Disclosure of reportable transactions (secs. 407 and 408 of the bill and secs. 6111 and 6707 of the Code)

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[165] A "tax shelter" means any investment with respect to which the tax shelter ratio[166] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and involving at least five investors).[167]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[168]

In general, a transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[169] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[170] Certain exceptions are provided with respect to the second category of transactions.[171]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax

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[165] Sec. 6111(a).

[166] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[167] Sec. 6111(c).

[168] Sec. 6111(d).

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

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

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

features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[172]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[173] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

Reasons for Change

The Committee has been advised that the current promoter registration rules have not proven particularly helpful, because the rules are not appropriate for the kinds of abusive transactions now prevalent, and because the limitations regarding confidential corporate arrangements have proven easy to circumvent.

The Committee believes that providing a single, clear definition regarding the types of transactions that must be disclosed by taxpayers and material advisors, coupled with more meaningful penalties for failing to disclose such transactions, are necessary tools if the effort to curb the use of abusive tax avoidance transactions is to be effective.

Explanation of Provision

Disclosure of reportable transactions by material advisors

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction (including any listed transaction)[174] to timely file an information return with the Secretary (in

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

[173] Sec. 6707.

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

such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[175]

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

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

Penalty for failing to furnish information regarding reportable transactions

The provision repeals the present law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[176] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.[177] All

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

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

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

or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

Effective Date

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

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

8. Modification of penalties for failure to register tax shelters or maintain lists of investors (secs. 407 and 409 of the bill and secs. 6112 and 6708 of the Code)

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[178] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[179] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[180]

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[178] Sec. 6112.

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

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

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[181] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[182] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[183]

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.[184]

Penalty for failing to maintain investor lists

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

Reasons for Change

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions.

Explanation of Provision

Investor lists

Each material advisor[185] with respect to a reportable transaction (including a listed transaction)[186] is required to maintain a list that (1) identifies each person with respect to whom

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

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

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

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

the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

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

Penalty for failing to maintain investor lists

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[187]

Effective Date

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

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

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

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

[186] The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related provisions.

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

9. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions (sec. 410 of the bill and sec. 7408 of the Code)

Present Law

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[188]

Reasons for Change

The Committee understands that some promoters are blatantly ignoring the rules regarding registration and list maintenance regardless of the penalties. An injunction would place these promoters in a public proceeding under court order. Thus, the Committee believes that the types of tax shelter activities with respect to which an injunction may be sought should be expanded.

Explanation of Provision

The provision expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[189] and the keeping of lists of investors by material advisors.[190] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

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

10. Understatement of taxpayer's liability by income tax return preparer (sec. 411 of the bill and sec. 6694 of the Code)

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

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[188] Sec. 7408.

[189] Sec. 6707, as amended by other provisions of this bill.

[190] Sec. 6708, as amended by other provisions of this bill.

Reasons for Change

The Committee believes that the standards of conduct applicable to income tax return preparers should be the same as the standards applicable to taxpayers. Accordingly, the minimum standard for each undisclosed position on a tax return would be that the preparer must reasonably believe that the tax treatment is more likely than not the proper tax treatment. The Committee believes that this standard is appropriate because the tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the facts and substantial accuracy in determining and applying the rules that govern those facts. The Committee believes that it is both appropriate and vital to the tax system that both taxpayers and their return preparers file tax returns that they reasonably believe are more likely than not correct. In addition, conforming the standards of conduct applicable to income tax return preparers to the standards applicable to taxpayers will simplify the law by reducing confusion inherent in different standards applying to the same behavior.

Explanation of Provision

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

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

Effective Date

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

11. Penalty on failure to report interests in foreign financial accounts (sec. 412 of the bill and sec. 5321 of Title 31, United States Code)

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[191] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

[191] 31 U.S.C. 5314.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[192] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[193]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[194] This report, which was statutorily required,[195] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Reasons for Change

The Committee understands that the number of individuals involved in using offshore bank accounts to engage in abusive tax scams has grown significantly in recent years. For one scheme alone, the IRS estimates that there may be hundreds of thousands of taxpayers with offshore bank accounts attempting to conceal income from the IRS. The Committee is concerned about this activity and believes that improving compliance with this reporting requirement is vitally important to sound tax administration, to combating terrorism, and to preventing the use of abusive tax schemes and scams. Adding a new civil penalty that applies without regard to willfulness will improve compliance with this reporting requirement.

Explanation of Provision

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

Effective Date

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

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[192] 31 U.S.C. 5321(a)(5).

[193] 31 U.S.C. 5322.

[194] *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

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

12. Frivolous tax submissions (sec. 413 of the bill and sec. 6702 of the Code)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[196] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Reasons for Change

The IRS has been faced with a significant number of tax filers who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for collection due process hearings, offers-in-compromise, installment agreements, and taxpayer assistance orders to impede or delay tax administration by raising frivolous arguments. These procedures were intended to provide assistance to taxpayers genuinely seeking to resolve legitimate disputes with the IRS, and the use of these procedures for impeding or delaying tax administration diverts scarce IRS resources away from resolving genuine disputes. Allowing the IRS to assert more substantial penalties for frivolous submissions and to dismiss frivolous requests without the need to follow otherwise mandated procedures will deter frivolous taxpayer behavior and enable the IRS to use its resources to better assist taxpayers in resolving genuine disputes.

Explanation of Provision

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

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

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

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[196] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

Effective Date

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

13. Regulation of individuals practicing before the Department of Treasury (sec. 414 of the bill and sec. 330 of Title 31, United States Code)

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[197] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Reasons for Change

The Committee believes that it is critical that the Secretary have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. Use of these sanctions is expected to curb the participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards.

Explanation of Provision

The provision makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the provision expressly permits censure as a sanction. Second, the provision permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

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

[197] 31 U.S.C. 330.

Effective Date

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

14. Penalty on promoters of tax shelters (sec. 415 of the bill and sec. 6700 of the Code)

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[198] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Reasons for Change

The Committee believes that the present-law penalty rate is insufficient to deter the type of conduct that gives rise to the penalty.

Explanation of Provision

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

Effective Date

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

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[198] Sec. 6700.

15. Statute of limitations for taxable years for which required listed transactions not disclosed (sec. 416 of the bill and sec. 6501 of the Code)

Present Law

In general, the Code requires that taxes be assessed within three years[199] after the date a return is filed.[200] If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[201] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[202]

Reasons for Change

The Committee believes that extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will encourage taxpayers to provide the required disclosure and will afford the IRS additional time to discover the transaction if the taxpayer does not disclose it.

Explanation of Provision

The provision extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[203] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner

[199] Sec. 6501(a).

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

[201] Sec. 6501(e).

[202] Sec. 6501(c).

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

required by Treasury regulations, then the transaction is subject to the extended statute of limitations.[204]

Effective Date

The provision is effective for taxable years with respect to which the period for assessing a deficiency did not expire before the date of enactment.

16. Denial of deduction for interest on underpayments attributable to nondisclosed reportable and noneconomic substance transactions (sec. 417 of the bill and sec. 163 of the Code)

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[205] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Reasons for Change

The Committee believes that it is inappropriate for corporations to deduct interest paid to the Government with respect to certain tax shelter transactions.

Explanation of Provision

The provision disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.[206]

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[204] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this provision does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the provision's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

[205] Sec. 163(a).

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

Effective Date

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

17. Authorization of appropriations for tax law enforcement (sec. 418 of the bill)

Present Law

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

Reasons for Change

The Committee believes that authorizing an additional $300 million to the Internal Revenue Service to be used to combat abusive tax avoidance transactions will aid in the implementation of the tax shelter measures the Committee is simultaneously approving.

Explanation of Provision

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

Effective Date

The provision is effective on the date of enactment.

B. Other Corporate Governance Provisions

1. Affirmation of consolidated return regulation authority (sec. 421 of the bill and sec. 502 of the Code)

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[207]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[208]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[209]

In the recent case of *Rite Aid Corp. v. United States*,[210] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

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[207] Sec. 1501.

[208] Sec. 1502.

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

[210] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.[211] The particular provision, known as the "duplicated loss" provision,[212] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[213]

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

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

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

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[214]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[215] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [216]

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

[214] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[215] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[216] *American Standard, Inc. v. United States,* 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[217]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[218]

Reasons for Change

The Committee is concerned that Treasury Department resources might be unnecessarily devoted to defending challenges to consolidated return regulations on the mere assertion by a taxpayer that the result under the consolidated return regulations is different than the result for separate taxpayers. The consolidated return regulations offer many benefits that are not available to separate taxpayers, including generally rules that tax income received by the group once and attempt to avoid a second tax on that same income when stock of a subsidiary is sold.

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returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[217] *Rite Aid*, 255 F.3d at 1360.

[218] *See* Temp. Reg. Sec. 1.1502-20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); and T.D. 9048, 68 F.R. 12287 (March 14, 2003).

The existing statute authorizes adjustments to clearly reflect the income of the group and of the separate members of the group, during and after the period of affiliation. The Committee believes that this standard, which is stated in the present law statute, should be reiterated.

Explanation of Provision

The bill confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that the Secretary is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision. The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, provided that such regulations are necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation.

The bill nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[219] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[220]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on

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

[220] The provision is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[221]

Effective Date.

The provision is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is intended that the results following from this provision are not the same as the results under present law.

2. Chief Executive Officer required to sign corporate income tax returns (sec. 422 of the bill and sec. 6062 of the Code)

Present Law

The Code requires[222] that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes[223] a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than $100,000[224] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

Reasons for Change

The Committee believes that the filing of accurate tax returns is essential to the proper functioning of the tax system. The Committee believes that requiring that the chief executive officer of a corporation sign a declaration that its corporate income tax return complies with the Internal Revenue Code will elevate both the level of care given to the preparation of those

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[221] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

[222] Sec. 6062.

[223] Sec. 7206.

[224] Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is $250,000.

returns and the level of compliance with the Code's requirements, which will in turn help ensure that the proper amount of tax is being paid.

Explanation of Provision

The provision requires that the chief executive officer of a corporation sign a declaration under penalties of perjury that the corporation's income tax return complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. This declaration is part of the income tax return. The provision is in addition to the requirement of present law as to the signing of the income tax return itself. Because a CEO's duties generally do not require a detailed or technical understanding of the corporation's tax return, it is anticipated that this declaration of the CEO will be more limited in scope than the declaration of the officer required to sign the return itself.

The Secretary of the Treasury shall prescribe the matters to which the declaration of the CEO applies. It is intended that the declaration help insure that the preparation and completion of the corporation's tax return be given an appropriate level of care. For example, it is anticipated that the CEO would declare that processes and procedures have been implemented to ensure that the return complies with the Internal Revenue Code and all regulations and rules promulgated thereunder. Although appropriate processes and procedures can vary for each taxpayer depending on the size and nature of the taxpayer's business, in every case the CEO should be briefed on all material aspects of the corporation's tax return by the corporation's chief financial officer (or another person authorized to sign the return under present law).

It is also anticipated that, as part of the declaration, the CEO would certify that, to the best of the CEO's knowledge and belief: (1) the processes and procedures for ensuring that the corporation files a tax return that complies with the requirements of the Code are operating effectively; (2) the return is true, accurate, and complete; (3) the officer signing the return did so under no compulsion to adopt any tax position with which that person did not agree; (4) the CEO was briefed on all listed transactions as well as all reportable tax avoidance transactions otherwise required to be disclosed on the tax return; and (5) all required disclosures have been filed with the return. The Secretary may by regulations prescribe additional requirements for this declaration.[225]

If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the declaration. It is intended that the IRS issue general guidance, such as a revenue procedure, to: (1) address situations when a corporation does not have a chief executive officer; and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title, when a corporation has multiple chief executive officers, or when the corporation is a

[225] Sec. 6011(a).

foreign corporation and the CEO is not a U.S. resident.[226] It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign this declaration.

The provision does not apply to the income tax returns of mutual funds;[227] they are required to be signed as under present law.

Effective Date

The provision is effective for returns filed after the date of enactment.

3. Denial of deduction for certain fines, penalties, and other amounts (sec. 423 of the bill and sec. 162 of the Code)

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[228]

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Reasons for Change

The Committee is concerned that there is a lack of clarity and consistency under present law regarding when taxpayers may deduct payments made in settlement of government

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[226] With respect to foreign corporations, it is intended that the rules for signing this declaration generally parallel the present-law rules for signing the return. See Treas. Reg. sec. 1.6062-1(a)(3).

[227] The provision does, however, apply to the income tax returns of mutual fund management companies and advisors.

[228] S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

investigations of potential wrongdoing, as well as in situations where there has been a final determination of wrongdoing. If a taxpayer deducts payments made in settlement of an investigation of potential wrongdoing or as a result of a finding of wrongdoing, the publicly announced amount of the settlement payment does not reflect the true after-tax penalty on the taxpayer. The Committee also is concerned that allowing a deduction for such payments in effect shifts a portion of the penalty to the Federal government and to the public.

Explanation of Provision

The bill modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the bill generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the governmental investigation or inquiry into the potential violation of any law [229] are nondeductible under any provision of the income tax provisions.[230] The bill applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.[231]

The bill applies only where a government (or other entity treated in a manner similar to a government under the bill) is a complainant or investigator with respect to the violation or potential violation of any law.[232]

It is intended that a payment will be treated as restitution only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed (or, in the case of property, not in compliance with the required standards) by

[229] The bill does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raises an issue of compliance and a payment is required in settlement of such issue, the bill would affect such payment. In such cases, the restitution exception could permit otherwise allowable deductions of amounts paid with respect to specific property or persons to avoid noncompliance or to bring the taxpayer into compliance with the required standards (for example, to bring a machine up to required emissions or other standards).

[230] The bill provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[231] The bill does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

[232] Thus, for example, the bill would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the provision.

the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.[233] Restitution is limited to the amount that bears a substantial quantitative relationship to the harm (or, in the case of property, to the correction of noncompliance) caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are restitution likewise applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the bill is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective Date

The bill is effective for amounts paid or incurred on or after April 28, 2003; however the bill does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained on or before April 27, 2003.

4. Denial of deduction for punitive damages (sec. 424 of the bill and sec. 162 of the Code)

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[234]

[233] Similarly, a payment to a charitable organization benefitting a substantially broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the provision, such a payment not deductible under section 162 would also not be deductible under section 170.

[234] Sec. 162(a).

However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[235] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[236] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[237]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[238] However, this exclusion does not apply to punitive damages.[239]

Reasons for Change

The Committee believes that allowing a tax deduction for punitive damages undermines the societal role of punitive damages in discouraging and penalizing the activities or actions for which punitive damages are imposed. Furthermore, the Committee believes that determining the amount of punitive damages to be disallowed as a tax deduction is not administratively burdensome because taxpayers generally can make such a determination readily by reference to pleadings filed with a court, and plaintiffs already make such a determination in determining the taxable portion of any payment.

Explanation of Provision

The provision denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective Date

The provision is effective for punitive damages that are paid or incurred on or after the date of enactment.

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[235] Sec. 162(c).

[236] Sec. 162(f).

[237] Sec. 162(g).

[238] Sec. 104(a).

[239] Sec. 104(a)(2).

5. Increase the maximum criminal fraud penalty for individuals to the amount of the tax at issue (sec. 425 of the bill and secs. 7201, 7203, and 7206 of the Code)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[240] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

Reasons for Change

In light of the recent reports of possibly criminal behavior in connection with the filing and preparation of tax returns, the Committee believes it is important to strengthen the criminal tax penalties.

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[240] Section 7206 states that this offense is a felony. In addition, it is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

Explanation of Provision

Attempt to evade or defeat tax

The provision increases the criminal penalty under section 7201 of the Code for individuals to $250,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The provision increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

Fraud and false statements

The provision increases the criminal penalty under section 7206 of the Code for individuals to $250,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to five years. The provision also provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective Date

The provision is effective for underpayments and overpayments attributable to actions occurring after the date of enactment.

C. Enron-Related Tax Shelter Provisions

1. Limitation on transfer and importation of built-in losses (sec. 431 of the bill and secs. 362 and 334 of the Code)

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[241] The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[242]

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.[243]

Reasons for Change

The Joint Committee on Taxation staff's investigative report of Enron Corporation[244] and other information reveal that taxpayers are engaging in various tax motivated transactions to duplicate a single economic loss and, subsequently, deduct such loss more than once. Congress has previously taken actions to limit the ability of taxpayers to engage in specific transactions that purport to duplicate a single economic loss. However, new schemes that purport to duplicate losses continue to proliferate. In furtherance of the overall tax policy objective of accurately measuring taxable income, the Committee believes that a single economic loss should not be deducted more than once. Thus, the Committee believes that it is generally appropriate to limit a corporation's basis in property acquired in a tax-free transfer to the fair market value of such property. In addition, the Committee believes that it is appropriate to prevent the importation of economic losses into the U.S. tax system if such losses arose prior to the assets becoming subject to the U.S. tax system.

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[241] Sec. 351.

[242] Sec. 358.

[243] Secs. 334(b) and 362(a) and (b).

[244] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

Explanation of Provision

Importation of built-in losses

The provision provides that if a net built-in loss is imported into the U.S in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the provision, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceeds the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U. S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if each partner had transferred such partner's proportionate share of the property of such partnership.

Limitation on transfer of built-in-losses in section 351 transactions

The provision provides that if the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate bases of the property is limited to the aggregate fair market value of the transferred property. Under the provision, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. In the case of a transfer after which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation, any basis reduction required by the provision is made to the stock received by the transferor and not to the assets transferred.

Effective Date

The provision applies to transactions after February 13, 2003.

2. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 432 of the bill and sec. 755 of the Code)

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.[245] Similarly, a partner and the partnership generally do not recognize

[245] Sec. 721(a).

gain or loss on the distribution of partnership property.[246] This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[247] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[248] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner and (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[249] In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and

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[246] Sec. 731(a) and (b).

[247] Sec. 732(b).

[248] Sec. 754.

[249] Sec. 755(a).

depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[250]

Reasons for Change

The Joint Committee on Taxation staff's investigative report of Enron Corporation[251] revealed that certain transactions were being undertaken that purported to use the interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock to obtain unintended tax results. These transactions generally purport to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner. Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The provision precludes the ability to reduce the basis of corporate stock of a partner (or related party) in certain transactions.

Explanation of Provision

The provision provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the provision, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective Date

The provision applies to distributions after February 13, 2003.

3. Repeal of special rules for FASITs (sec. 433 of the bill and secs. 860H through 860L of the Code)

Present Law

Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.[252] A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

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[250] Sec. 755(b).

[251] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

[252] Sections 860H through 860L.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[253] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

"Regular interests" of a FASIT

"Regular interests" of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest", an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a

[253] Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT's owner (or a person related to the FASIT's owner), the property is treated as being first acquired by the FASIT's owner for the FASIT's cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules.–In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

Real estate mortgage investment conduits

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[254] In order to qualify as a REMIC, substantially all of the assets of the entity must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder

[254] *See* sections 860A through 860G.

to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

Original issue discount accruals with respect to debt instruments and pools of debt instruments subject to acceleration of principal payment

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.[255] In general, issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments and pools of instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a REMIC or qualified mortgage held by a REMIC, (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, or (3) any pool of debt instruments the yield on which may be affected by reason of prepayments, the daily portions of the OID on such debt instruments and pools of debt instruments generally are determined by taking into account an assumption regarding the prepayment of principal for such instruments. The prepayment assumption to be used for this purpose is that which the parties use in pricing the particular transaction.

Reasons for Change

The Joint Committee on Taxation staff's investigative report of Enron Corporation[256] described two structured tax-motivated transactions--Projects Apache and Renegade--that Enron

[255] The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

[256] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

undertook in which the use of a FASIT was a key component in the structure of the transactions. The Committee is aware that FASITs are not being used widely in the manner envisioned by the Congress and, consequently, the FASIT rules have not served the purpose for which they originally were intended. Moreover, the Joint Committee's report indicates that FASITs are particularly prone to abuse and likely are being used primarily to facilitate tax avoidance transactions. Therefore, the Committee believes that the potential for abuse that is inherent in FASITs far outweighs any beneficial purpose that the FASIT rules may serve. Accordingly, the Committee believes that these rules should be repealed, with appropriate transition relief for existing FASITs and appropriate modifications to the present-law REMIC rules to permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by an interest in real property.

Explanation of Provision

The provision repeals the special rules for FASITs. The provision provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the provision also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the provision modifies the present-law definition of a REMIC "regular interest" to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the provision makes three modifications to the present-law definition of a "qualified mortgage." First, the provision modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the provision modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a "reverse mortgage loan" is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the provision modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the provision modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

The provision also modifies the OID rules with respect to certain instruments and pools of instruments that may be subject to principal prepayment by directing the Secretary to prescribe regulations permitting the use of a current prepayment assumption determined as of the close of the accrual period (or such other time as the Secretary may prescribe during the taxable year in which the accrual period ends).

Effective Date

Except as provided by the transition period for existing FASITs, the provision is effective after February 13, 2003.

4. Expanded disallowance of deduction for interest on convertible debt (sec. 434 of the bill and sec. 163 of the Code)

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Under present law, no deduction is allowed for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into equity of the issuer or a related party.[257] In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of equity of the issuer or related party.[258] A debt instrument also is treated as payable in equity if it is part of an arrangement that is designed to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that option will be exercised.[259]

Reasons for Change

The Joint Committee on Taxation staff's investigative report of Enron Corporation[260] described two structured financing transactions that Enron undertook in 1995 and 1999 involving what the report referred to as "investment unit securities." In substance, these securities featured principal repayment that was not unconditional in amount, as generally is required in order for debt characterization to be respected for tax purposes. Instead, principal on the securities was payable upon maturity in stock of an Enron affiliate (or in cash equivalent to the value of such stock).

The Committee believes that the financing activities undertaken by Enron in 1995 and 1999 using investment unit securities cast doubt upon the tax policy rationale for excluding stock ownership interests of 50 percent or less (by virtue of the present-law related party definition) from the application of the interest expense disallowance rules for certain convertible equity-linked debt instruments. With regard to the securities issued by Enron, the fact that Enron owned more than 50 percent of the affiliate stock at the time of the 1995 issuance but owned less than 50 percent of such stock at the time of the 1999 issuance (or shortly thereafter) had no discernible bearing on the intent or economic consequences of either transaction. In each instance, the transaction did not involve a borrowing by Enron in substance for which an interest deduction is appropriate. Rather, these transactions had the purpose and effect of carrying out a monetization of the affiliate stock. Nevertheless, the tax consequences of the 1995 issuance likely would have been different from those of the 1999 issuance if the present-law rules had been in effect at the time of both transactions, rather than only at the time of the 1999 transaction (to which the interest expense disallowance rules did not apply because of the present-law 50-

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[257] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

[258] Sec. 163(l)(3)(B).

[259] Sec. 163(l)(3)(C).

[260] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

percent related party threshold). Therefore, the Committee believes that eliminating the related party threshold for the application of these rules furthers the tax policy objective of similar tax treatment of economically equivalent transactions. The Committee further believes that disallowed interest under this provision should increase the basis of the equity to which the equity is linked in a manner similar to that contemplated under currently proposed Treasury regulations.[261]

Explanation of Provision

The provision expands the present-law disallowance of interest deductions on certain corporate convertible or equity-linked debt that is payable in, or by reference to the value of, equity. Under the provision, the disallowance is expanded to include interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or any related party) in any other person, without regard to whether such equity represents more than a 50-percent ownership interest in such person. The basis of such equity is increased by the amount of interest deductions that is disallowed by the provision. The provision directs the Treasury Department to issue regulations that provide rules for determining the manner in which the basis of equity held by the issuer (or related party) is increased by the amount of interest deductions that is disallowed under the provision.

The provision does not apply to debt that is issued by an active dealer in securities (or a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

Effective Date

This provision applies to debt instruments that are issued after February 13, 2003.

5. Expanded authority to disallow tax benefits under section 269 (sec. 435 of the bill and sec. 269 of the Code)

Present Law

Section 269 provides that if a taxpayer acquires, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary may disallow the such tax benefits.[262] Similarly, if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately before the acquisition), the basis of such property is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose of the

[261] Prop. Treas. reg. sec. 1.263(g)-4.

[262] Sec. 269(a)(1).

acquisition is the evasion or avoidance of Federal income tax by securing a tax benefit that would not otherwise have been available, the Secretary may disallow such tax benefits.[263]

Reasons for Change

The Joint Committee on Taxation staff's investigative report of Enron Corporation[264] highlights the limited reach of section 269. Present-law section 269, as it applies to the acquisition of property, is circumscribed because it only applies to tax benefits that can be obtained only through the acquisition of control. The Committee believes it is appropriate to expand section 269 by the removal of such requirement.

Explanation of Provision

The provision expands section 269 by repealing the requirement that the acquisition of property be from a corporation not controlled by the acquirer. Thus, under the provision, section 269 disallows the tax benefits of (1) any acquisition of stock sufficient to obtain control of a corporation (as under present law), and (2) any acquisition by a corporation of property from a corporation in which the basis of such property is determined by reference to the basis in the hands of the transferor corporation, if the principal purpose of such acquisition is the evasion or avoidance of Federal income tax.

Effective Date

The provision applies to stock and property acquired after February 13, 2003.

6. Modification of interaction between subpart F and passive foreign investment company rules (sec. 436 of the bill and sec. 1297 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[265] and the passive foreign investment

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[263] Sec. 269(a)(2).

[264] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

[265] Secs. 951-964.

company rules.[266] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[267]

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

Subpart F,[268] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[269] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[270]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[271] insurance income,[272] and certain income relating to international boycotts and other violations of public policy.[273] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign

[266] Secs. 1291-1298.

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

[268] Secs. 951-964.

[269] Secs. 951(b), 957, 958.

[270] Sec. 951(a).

[271] Sec. 954.

[272] Sec. 953.

[273] Sec. 952(a)(3)-(5).

base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[274]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[275]

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[276] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[277] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[278] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[279]

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation's subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S.

[274] Sec. 954.

[275] Secs. 951(a)(1)(B), 956.

[276] Sec. 1297.

[277] Sec. 1293-1295.

[278] Sec. 1291.

[279] Sec. 1296.

shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

Reasons for Change

The Committee is aware that section 1297(e) may enable a U.S. shareholder (like Enron Corporation in its "Project Apache" transaction)[280] to claim exemption from the passive foreign investment company rules with respect to ownership of controlled foreign corporation stock on the basis of mere status as a U.S. shareholder, despite the fact that the U.S. shareholder may have implemented a structure intended to render it impossible for such shareholder to recognize any income under subpart F in connection with the stock. The Committee believes that the passive foreign investment company rules should be available to serve as a backstop to subpart F in such circumstances, and thus believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder's potential taxability under subpart F, as opposed to mere status as a U.S. shareholder under subpart F.

Explanation of Provision

The provision adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

Effective Date

The provision is effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

[280] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, vol. I at 255, 258-59.

D. Provisions to Discourage Expatriation

1. Tax treatment of inversion transactions (sec. 441 of the bill and new sec. 7874 of the Code)

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[281] and the passive foreign investment company rules.[282] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

[281] Secs. 951-964.

[282] Secs. 1291-1298.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

Under present law, U.S. corporations may reincorporate in foreign jurisdictions and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as "inversion" transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various "earnings stripping" or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to related parties, if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income." More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an "arm's length" standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under sections 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Reasons for Change

The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations. The Committee believes that certain inversion transactions (involving 80 percent or greater identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes. The Committee believes that other inversion transactions (involving greater than 50 but less than 80 percent identity of stock ownership) may have sufficient non-tax effect and purpose to be respected, but warrant heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions.

Explanation of Provision

In general

The provision defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[283] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[284]

Except as otherwise provided in regulations, the provision does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in a public offering (whether initial or secondary) or private placement related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person, a member of an expanded affiliated group, or a publicly traded corporation. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

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[283] It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

[284] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.

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

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the accuracy-related penalty is increased; and (3) section 163(j), relating to "earnings stripping" through related-party debt, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

The 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to taxpayers related to the inverted entity. In addition, the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers.

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

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

<u>Partnership transactions</u>

Under the provision, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the provision apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership (whether or not publicly traded), if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

2. Impose mark-to-market tax on individuals who expatriate (sec. 442 of the bill and secs. 102, 877, 2107, 2501, 7701 and 6039G of the Code)

Present Law

In general

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign-source income. Nonresidents who are not U.S. citizens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business.

Income tax rules with respect to expatriates

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the expatriation or residency termination under section 877. The alternative method of taxation for expatriates modifies the rules generally applicable to the taxation of nonresident noncitizens in several ways. First, the individual is subject to tax on his or her U.S.-source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident noncitizens. Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign-source income. Second, the scope of items treated as U.S.-source income for section 877 purposes is broader than those items generally considered to be U.S.-source income under the Code.[285] Third, individuals

[285] For example, gains on the sale or exchange of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S.-source income under the Code. Thus, such gains would not be taxable to a nonresident noncitizen. However, if an individual is subject to the alternative regime under sec. 877, such gains are treated as U.S.-source income with respect to that individual.

subject to section 877 are taxed on exchanges of certain types of property that give rise to U.S.-source income for property that gives rise to foreign-source income.[286] Fourth, an individual subject to section 877 who contributes property to a controlled foreign corporation is treated as receiving income or gain from such property directly and is taxable on such income or gain. The alternative method of taxation for expatriates applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident noncitizen.

The expatriation tax provisions apply to long-term residents of the United States whose U.S. residency is terminated. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty).

Subject to the exceptions described below, an individual is treated as having expatriated or terminated residency with a principal purpose of avoiding U.S. taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of the individual's loss of U.S. citizenship or termination of U.S. residency is greater than $100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is $500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. An individual who falls below these thresholds is not automatically treated as having a principal purpose of tax avoidance, but nevertheless is subject to the expatriation tax provisions if the individual's loss of citizenship or termination of residency in fact did have as one of its principal purposes the avoidance of tax.

Certain exceptions from the treatment that an individual relinquished his or her U.S. citizenship or terminated his or her U.S. residency for tax avoidance purposes may also apply. For example, a U.S. citizen who loses his or her citizenship and who satisfies either the tax liability test or the net worth test (described above) can avoid being deemed to have a principal purpose of tax avoidance if the individual falls within certain categories (such as being a dual citizen) and the individual, within one year from the date of loss of citizenship, submits a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes.

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[286] For example, a former citizen who is subject to the alternative tax regime and who removes appreciated artwork that he or she owns from the United States could be subject to immediate U.S. tax on the appreciation. In this regard, the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of $250,000 within the 15-year period beginning five years prior to the expatriation will be treated as an "exchange" subject to these rules.

Estate tax rules with respect to expatriates

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.[287] Such property includes real estate and tangible property located within the United States. Moreover, for estate tax purposes, stock held by nonresident noncitizens is treated as U.S.-situated if issued by a U.S. corporation.

Special rules apply to U.S. citizens who relinquish their citizenship and long-term residents who terminate their U.S. residency within the 10 years prior to the date of death, unless the loss of status did not have as one its principal purposes the avoidance of tax (sec. 2107). Under these rules, the decedent's estate includes the proportion of the decedent's stock in a foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation. This rule applies only if (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.

Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Gift tax rules with respect to expatriates

Nonresident noncitizens generally are subject to gift tax on certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Unlike the estate tax rules for U.S. stock held by nonresidents, however, nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Special rules apply to U.S. citizens who relinquish their U.S. citizenship or long-term residents of the United States who terminate their U.S. residency within the 10 years prior to the date of transfer, unless such loss did not have as one of its principal purposes the avoidance of tax (sec. 2501(a)(3)). Under these rules, nonresident noncitizens are subject to gift tax on transfers of intangibles, such as stock or securities. Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a

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

timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Other tax rules with respect to expatriates

The expatriation tax provisions permit a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate, or similar taxes paid with respect to the items subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability.

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least $500,000, and such other information as the Secretary may prescribe. The information statement must be provided no later than the earliest day on which the individual (1) renounces the individual's U.S. nationality before a diplomatic or consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is canceled by a U.S. court. The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) $1,000.

The State Department is required to provide the Secretary of the Treasury with a copy of each certificate of loss of nationality approved by the State Department. Similarly, the agency administering the immigration laws is required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned. Further, the Secretary of the Treasury is required to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or certificates of loss of nationality it receives under the foregoing information-sharing provisions.

Immigration rules with respect to expatriates

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.

Reasons for Change

The Committee is aware that some individuals each year relinquish their U.S. citizenship or terminate their U.S. residency for the purpose of avoiding U.S. income, estate, and gift taxes. By so doing, such individuals reduce their annual U.S. income tax liability and reduce or eliminate their U.S. estate tax liability.

The Committee recognizes that citizens and residents of the United States have a right not only physically to leave the United States to live elsewhere, but also to relinquish their citizenship or terminate their residency. The Committee does not believe that the Internal Revenue Code should be used to stop U.S. citizens and residents from relinquishing citizenship or terminating residency; however, the Committee also does not believe that the Code should provide a tax incentive for doing so. In other words, to the extent possible, an individual's decision to relinquish citizenship or terminate residency should be tax-neutral.

The Committee is concerned that the present-law expatriation tax rules are difficult to administer. In addition, the Committee is concerned that the alternative method of taxation under section 877 can be avoided by postponing the realization of U.S.-source income for 10 years. The Committee believes that the expatriation tax rules are largely ineffective in taxing U.S. citizens and residents who relinquish citizenship or terminate residency with a principal purpose to avoid tax.

The Committee believes that the present-law expatriation tax rules should be replaced with a tax regime applicable to former citizens and residents that does not rely on establishing a tax avoidance motive. Because U.S. citizens and residents who retain their citizenship or residency generally are subject to income tax on accrued appreciation when they dispose of their assets, as well as estate tax on the full value of assets that are held until death, the Committee believes it fair to tax individuals on the appreciation in their assets when they relinquish their citizenship or terminate their residency. The Committee believes that an exception from such a tax should be provided for individuals with a relatively modest amount of appreciated assets. The Committee also believes that, where U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to an income tax based on the value of the property.

The Committee also believes that the present-law immigration rules applicable to former citizens are ineffective. The Committee believes that the rules should be modified to eliminate the requirement of proof of a tax avoidance purpose, and to coordinate the application of those rules with the tax rules provided under the new regime.

Explanation of Provision

In general

The provision generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2002.

Individuals covered

Under the provision, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Election to be treated as a U.S. citizen

Under the provision, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Date of relinquishment of citizenship

Under the provision, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon expatriation or residency termination

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the provision. Regulatory authority is granted to the Treasury to except other types of property from the provision.

Under the provision, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Retirement plans and similar arrangements

Subject to certain exceptions, the provision applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[288] However, the provision contains a special rule for an interest in a "qualified retirement plan." For purposes of the provision, a "qualified retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer

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[288] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

(sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the provision, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

Deferral of payment of tax

Under the provision, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Interests in trusts

Under the provision, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these provision. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.–If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.–If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual’s death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual’s interest in a trust is vested as of the expatriation date (e.g., if the individual’s interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual’s trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual’s interest in the trust is not vested as of the expatriation date (e.g., if the individual’s trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual’s favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The provision provides a coordination rule with the present-law alternative tax regime. Under the provision, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after February 5, 2003.

Treatment of gifts and inheritances from a former citizen or former long-term resident

Under the provision, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Information reporting

The provision provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the provision.

Immigration rules

The provision amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the provision's expatriation tax provisions (regardless of the subjective motive for expatriating). For this purpose, the provision permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the provision would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this provision.

Effective Date

The provision generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after February 5, 2003. The provisions relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after February 5, 2003, whose expatriation or residency termination occurs on or after such date. The provisions relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

3. Excise tax on stock compensation of insiders of inverted corporations (sec. 443 of the bill and new sec. 5000A of the Code)

Present Law

The income taxation of a nonstatutory[289] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[290] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Reasons for Change

The Committee believes that certain inversion transactions are a means of avoiding U.S. tax and should be curtailed. The Committee is concerned that, while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions. Since such executives are often instrumental in deciding whether to engage in inversion transactions, the Committee believes that, upon certain inversion transactions, it is appropriate to impose an excise tax on certain executives holding stock options and other stock-based compensation.

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[289] Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

[290] If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

Explanation of Provision

Under the provision, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The provision imposes a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's inversion date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or would be subject to such requirements if the corporation was an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[291] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the bill.

Specified stock compensation subject to the excise tax includes any payment[292] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group[293]) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified

[291] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

[292] Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

[293] An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual is paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the provision because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the inversion transaction, and to any specified stock compensation awarded in the six-month period beginning with the inversion transaction. As a result, for example, if a corporation were to cancel outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Treasury Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable twelve-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the provision, the excise tax does not apply to any stock option that is exercised on the inversion date or during the six-month period before such date and to the stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the inversion date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which gain or loss is recognized in full.

For specified stock compensation held on the inversion date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the inversion date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the inversion date is valued on the date granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Treasury Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the provision. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the inverted corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Treasury Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance would include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the provision, the Treasury Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the section.

Effective Date

The provision is effective as of July 11, 2002, except that periods before July 11, 2002, are not taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the inversion date.

4. Reinsurance agreements (sec. 444 of the bill and sec. 845 of the Code)

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[294] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[295] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Reasons for Change

The Committee is concerned that reinsurance transactions are being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons. The Committee is concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base. The Committee believes that the provision of present law permitting the Treasury Secretary to allocate or recharacterize items related to a reinsurance

[294] Sec. 845(a).

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

agreement should be applied to prevent misallocation, improper characterization, or to make any other adjustment in the case of such reinsurance transactions between U.S. and foreign related persons (or agents or conduits). The Committee also wishes to clarify that, in applying the authority with respect to reinsurance agreements, the amount, source or character of the items may be allocated, recharacterized or adjusted.

Explanation of Provision

The provision clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The provision authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[296] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

No regulations have been issued under section 845(a). It is expected that the Treasury Secretary will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

Effective Date

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

5. Reporting of taxable mergers and acquisitions (sec. 445 of the bill and new sec. 6043A of the Code)

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

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

Reasons for Change

The Committee believes that administration of the tax laws would be improved by greater information reporting with respect to taxable non-cash transactions, and that the Treasury Secretary's authority to require such enhanced reporting should be made explicit in the Code.

Explanation of Provision

Under the provision, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[297]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements is extended to failures to comply with the requirements set forth under the provision.

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[297] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

Effective Date

The provision is effective for acquisitions after the date of enactment.

E. International Tax

1. Clarification of banking business for purposes of determining investment of earnings in U.S. property (sec. 451 of the bill and sec. 956 of the Code)

Present Law

In general, the subpart F rules[298] require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property.[299]

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[300] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[301] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[302]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a

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[298] Secs. 951-964.

[299] Sec. 951(a)(1)(B).

[300] Sec. 956(a).

[301] Secs. 956 and 959.

[302] Secs. 951(a)(1)(B) and 959.

secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[303]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[304]

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[305] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

Reasons for Change

The Committee believes that further guidance is necessary under the U.S. property investment provisions of subpart F with regard to the treatment of deposits with persons carrying on the banking business. In particular, the Committee believes that the transaction at issue in *The Limited* case was not contemplated or intended by Congress when it excepted from the definition of U.S. property deposits with persons carrying on the banking business. Therefore, the Committee believes that it is appropriate and necessary to clarify the scope of this exception so that it applies only to deposits with regulated banking businesses and their affiliates.

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[303] Sec. 956(c)(1).

[304] Sec. 956(c)(2).

[305] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

Explanation of Provision

The provision provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with: (1) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c), without regard to paragraphs (C) and (G) of paragraph (2) of such section); or (2) any other corporation with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited*.

Effective Date

This provision is effective on the date of enactment.

2. Prohibition on nonrecognition of gain through complete liquidation of holding company (sec. 452 of the bill and sec. 332 of the Code)

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

Reasons for Change

The Committee is concerned that foreign corporations may establish a U.S. holding company to receive tax-free dividends from U.S. operating companies, liquidate the U.S. holding company to distribute the U.S. earnings free of U.S. withholding taxes, and then reestablish another U.S. holding company, with the intention of escaping U.S. withholding taxes. The Committee believes that instances of such withholding tax abuse will be significantly restricted by imposing U.S. withholding taxes on a liquidating distribution to foreign corporate shareholders of earnings and profits of a U.S. holding company created within five years of the liquidation.

Explanation of Provision

The provision treats as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

Effective Date

The provision is effective for distributions occurring on or after the date of enactment.

3. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 453 of the bill and secs. 163 and 267 of the Code)

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (sections 951-964), the passive foreign investment company rules (sections 1291-1298), and the foreign personal holding company rules (sections 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[306] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[307] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[308]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[309] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[310] As in the case of OID, the Treasury regulations additionally provide that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[311]

Reasons for Change

The special rules in the Treasury regulations for FPHCs, CFCs and PFICs are an exception to the general rule that OID and unpaid interest owed to a related foreign person are deductible when paid (i.e., under a cash method). These special rules were deemed appropriate in the case of FPHCs, CFCs and PFICs because it was thought that there would be little material

[306] Section 163(e)(1).

[307] Section 163(e)(3).

[308] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue has in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[309] Section 267(a)(2).

[310] Treas. Reg. sec. 1.267(a)-3(b)(1), (c).

[311] Treas. Reg. sec. 1.267(a)-3(c)(4).

distortion in matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for U.S. tax purposes pursuant to the FPHC, subpart F or PFIC provisions. The Committee believes that this premise fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholders. Consequently, under the Treasury regulations, both the U.S. payors and U.S.-owned foreign payors may be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income. These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

Explanation of Provision

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of all of the direct or indirect U.S. owners of the related foreign person under the relevant inclusion rules. Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid. The provision grants the Secretary regulatory authority to provide exceptions to these rules, including an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged.

Effective Date

The provision is effective for payments accrued on or after date of enactment.

4. Effectively connected income to include certain foreign source income (sec. 454 of the bill and sec. 864 of the Code)

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[312] Foreign persons also are subject to a 30-percent gross-basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

[312] Sections 871(b) and 882.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[313] The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a U.S. trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income (sometimes referred to as the "force of attraction rule").

In general, foreign-source income is not treated as U.S.-effectively connected income.[314] However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories described below.[315] For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.[316]

The first category consists of rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trademarks, trade brands, franchises, or other similar intangible properties derived in the active conduct of the U.S. trade or business.[317] The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.[318] Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock.[319] The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the

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[313] Section 864(c).

[314] Section 864(c)(4).

[315] Section 864(c)(4)(B).

[316] Section 864(c)(5).

[317] Section 864(c)(4)(B)(i).

[318] Section 864(c)(4)(B)(ii).

[319] Section 864(c)(4)(D)(i).

United States through the foreign person's U.S. office or other fixed place of business.[320] Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale or exchange.

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties, and personal services income.[321] For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules.[322] In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected with a U.S. trade or business.[323] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient of the income, but is treated as U.S.-source effectively connected income if it arises from the conduct of a United States trade or business.[324]

Reasons for Change

The Committee believes that present law creates arbitrary distinctions between economically similar transactions that are equally related to a U.S. trade of business. The Committee believes that the rules for determining whether foreign-source income (e.g., interest and dividends) is U.S.-effectively connected income should be the same as the rules for determining whether income that is economically equivalent to such foreign-source income is U.S.-effectively connected income.

Explanation of Provision

Each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such

[320] Section 864(c)(4)(B)(iii).

[321] Sections 861 through 865.

[322] See *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982).

[323] Treas. Reg. sec. 1.864-5(b)(2)(ii).

[324] Treas. Reg. sec. 1.863-7(b)(3).

economic equivalents are treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Effective Date

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

5. Recapture of overall foreign losses on sale of controlled foreign corporation stock (sec. 455 of the bill and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to a portion of the taxpayer's U.S. tax which portion is calculated by multiplying the taxpayer's total U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) and the denominator of which is the taxpayer's worldwide taxable income for the year.[325] Separate limitations are applied to specific categories of income.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation.[326] Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income.[327] The amount resourced as U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured.[328] In this regard, dispositions of trade

[325] Section 904(a).

[326] Section 904(f).

[327] Section 904(f)(1).

[328] Section 904(f)(3).

or business property used predominantly outside the United States are treated as resulting in the recognition of foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such income would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[329]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income).[330] Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock, for purposes of the interest apportionment.

Reasons for Change

The Committee believes that dispositions of corporate stock should be subject to the special recapture rules for overall foreign losses. Ownership of stock in a foreign subsidiary can lead to, or increase, an overall foreign loss as a result of interest expenses allocated against foreign-source income under the interest expense allocation rules. The recapture of overall foreign losses created by such interest expense allocations may be avoided if, for example, the stock of the foreign subsidiary subsequently were transferred to unaffiliated parties in non-taxable transactions. The Committee believes that overall foreign losses should be recaptured

[329] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Section 367(a)(3)(C).

[330] Section 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

when stock of a controlled foreign corporation is disposed of regardless of whether such stock is disposed of a non-taxable transaction.

Explanation of Provision

Under the provision, the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets applies to the disposition of controlled foreign corporation stock. Thus, dispositions of controlled foreign corporation stock result in the recognition of foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income is resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Effective Date

The provision applies to dispositions after the date of enactment.

6. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends (sec. 456 of the bill and sec. 901 of the Code)

Present Law

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

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

Reasons for Change

The Committee believes that the present-law holding period requirement for claiming foreign tax credits with respect to dividends is too narrow in scope and, in general, should be extended to apply to items of income or gain other than dividends, such as interest.

Explanation of Provision

The provision expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The provision does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The provision also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the provision. In addition, the provision authorizes the Treasury Department to issue regulations providing that the provision does not apply in appropriate cases.

Effective Date

The provision is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

F. Other Revenue Provisions

1. Treatment of stripped interests in bond and preferred stock funds, etc. (sec. 461 of the bill and secs. 305 and 1286 of the Code)

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[331]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).[332] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[333]

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[331] *Helvering v. Horst*, 311 U.S. 112 (1940).

[332] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[333] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[334] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[335] In general, upon the disposition of either the stripped bond or the detached interest coupons each of the retained portion and the portion that is disposed is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[336] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[337] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained

[334] Sec. 1286.

[335] Sec. 1286(e).

[336] Sec. 1286(a).

[337] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[338]

Stripped preferred stock

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[339] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[340] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[341]

Reasons for Change

The Committee is concerned that taxpayers are entering into tax avoidance transactions to generate artificial losses, or defer the recognition of ordinary income and convert such income into capital gains, by selling or purchasing stripped interests that are not subject to the present-law rules relating to stripped bonds and preferred stock but that represent interests in bonds or preferred stock. Therefore, the Committee believes that it is appropriate to provide Treasury with regulatory authority to apply such rules to interests that do not constitute bonds or preferred stock but nevertheless derive their economic value and characteristics exclusively from underlying bonds or preferred stock.

Explanation of Provision

The provision authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The provision applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

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[338] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[339] Sec. 305(e)(5).

[340] Sec. 305(e)(1).

[341] Sec. 305(e)(3).

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,[342] *modifying and superceding* Rev. Proc. 2002-16.[343]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

Effective Date

The provision is effective for purchases and dispositions occurring after the date of enactment.

2. Application of earnings-stripping rules to partnerships and S corporations (sec. 462 of the bill and sec. 163 of the Code)

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[344] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

The present-law earnings stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as debt of the corporate partner for purposes of applying the earnings

[342] 2002-43 I.R.B. 753.

[343] 2002-9 I.R.B. 572.

[344] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

stripping limitation to its own interest payments.[345] In addition, interest paid or accrued by a partnership is treated as interest expense of a corporate partner, with the result that a deduction for the interest expense may be disallowed if that expense would be disallowed under the earnings stripping rules if paid by the corporate partner itself.[346] The proposed regulations also provide that the earnings stripping rules do not apply to subchapter S corporations.[347] Thus, under present law and the proposed regulations, a partnership or S corporation generally is allowed a deduction for interest paid or accrued on indebtedness that it issues that otherwise would be disallowed under the earnings stripping rules in the case of a subchapter C corporation.

Reasons for Change

The Committee is concerned that the present-law earnings-stripping rules do not prevent U.S. partnerships and S corporations from reducing their U.S.-source taxable income through earnings-stripping transactions. The Committee also is concerned that subchapter C corporations are avoiding the application of the present-law earnings-stripping rules through the use of partnerships. Although proposed Treasury regulations would address some of these concerns, the Committee believes that it is necessary to modify the statutory earnings-stripping rules to apply to U.S. partnerships and S corporations, as well as to corporate partners to the extent of their proportionate shares in partnership debt.

Explanation of Provision

The provision provides that the deduction for interest paid or accrued by partnerships and S corporations is subject to disallowance under the earnings stripping rules if the partnership or S corporation meets the tests that would apply under present law if the partnership or S corporation were a C corporation. Thus, for example, the deduction for interest paid by a partnership to a related person that is exempt from tax would be disallowed if the debt-equity ratio of the partnership exceeds 1.5 to 1 and the interest expense of the partnership exceeds 50 percent of the partnership's adjusted taxable income. As a result, no deduction for this interest would be available to any of the partners. Although an S corporation cannot have foreign shareholders under present law, "disqualified interest" subject to the earnings stripping rules would include interest paid to tax-exempt organizations that are shareholders of the S corporation and interest paid to other related parties as defined under present law.

The provision incorporates a rule attributing partnership debt to a corporate partner for purposes of applying the earnings stripping rules to the corporation.[348] The rule attributing partnership interest expense to corporate partners for potential disallowance under the earnings stripping rules[349] apply under the provision only after the earnings stripping rules have been

[345] Prop. Treas. reg. sec. 1.163(j)-3(b)(3).

[346] Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[347] Prop. Treas. reg. sec. 1.163(j)-1(a)(i).

[348] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[349] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

applied at the partnership level. If interest expense of the partnership is disallowed under the provision, there is no deduction allocated to the corporate partners. If the interest deduction is not disallowed at the partnership level, the amount allocated to a corporate partner would be subject again to disallowance under the proposed Treasury regulations based upon the attributes of the corporate partner.

Effective Date

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

3. Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest (sec. 463 of the bill and sec. 108 of the Code)

Present Law

Under present law, a corporation that transfers shares of its stock in satisfaction of its debt must recognize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock.[350] Prior to enactment of this present-law provision in 1993, case law provided that a corporation did not recognize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of debt (referred to as the "stock-for-debt exception").[351]

When cancellation of indebtedness income is realized by a partnership, it generally is allocated among the partners in accordance with the partnership agreement, provided the allocations under the agreement have substantial economic effect. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations.[352] The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

In the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly requires the partnership to realize cancellation of indebtedness income. Thus, it is unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt

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[350] Sec. 108(e)(8).

[351] *E.g.*, *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *nonacq.* 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.* 1943 C.B. 1.

[352] Sec. 108(a).

exception. It also is unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[353]

Reasons for Change

The Committee believes that further guidance is necessary with regard to the application of the stock-for-debt exception in the context of transfers of partnership interests in satisfaction of partnership debt. In particular, the Committee believes that it is necessary to clarify that the present-law treatment of corporate indebtedness that is satisfied with transfers of stock of the debtor corporation also applies to partnership indebtedness that is satisfied with transfers of capital or profits interests in the debtor partnership.

Explanation of Provision

The provision provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The provision applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the provision is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the provision, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Effective Date

This provision is effective for cancellations of indebtedness occurring on or after the date of enactment.

4. Modification of straddle rules (sec. 464 of the bill and sec. 1092 of the Code)

Present Law

In general

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to

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[353] *See, e.g.*, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934); *American Seating Co. v. Commissioner*, 14 B.T.A. 328, *aff'd in part and rev'd in part*, 50 F.2d 681 (7th Cir. 1931); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940); Rev. Rul. 91-31, 1991-1 C.B. 19.

a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[354] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

Positions in stock

The straddle rules also generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Although the straddles rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules do not apply if the option is a "qualified covered call option" written by the taxpayer. In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

The stock exception from the straddle rules has been curtailed severely by legislative amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[355]

Unbalanced straddles

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[356] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and

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[354] Sec. 1092.

[355] Prop. Treas. Reg. sec. 1.1092(d)-2(c).

[356] Sec. 1092(c)(2)(B).

sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[357] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[358] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock--i.e., the number of shares specified in the costless collar--because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) and (3) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

Reasons for Change

The Committee believes that the straddle rules should be modified in several respects. While the present-law rules provide authority for the Treasury Secretary to issue guidance concerning unbalanced straddles, the Committee is of the view that such guidance is not forthcoming. Therefore, the Committee believes that it is necessary at this time to provide such guidance by statute. The Committee further believes that it is appropriate to repeal the exception from the straddle rules for positions in stock, particularly in light of statutory changes in the straddle rules and elsewhere in the Code that have significantly diminished the continuing utility of the exception. In addition, the Committee believes that the present-law treatment of physically settled positions under the straddle rules requires clarification.

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[357] Priv. Ltr. Rul. 199925044 (Feb. 3, 1999).

[358] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

Explanation of Provision

The bill modifies the straddle rules in three respects: (1) permit taxpayers to identify offsetting positions of a straddle; (2) provide a special rule to clarify the present-law treatment of certain physically settled positions of a straddle; and (3) repeal the stock and qualified covered call exceptions from the straddle rules.

Under the bill, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle.[359] If there is a loss with respect to any identified position that is part of an identified straddle, the general straddle loss deferral rules do not apply to such loss. Instead, the basis of each of the identified positions that offset the loss position in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain (if any) with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all positions that offset the loss position in the identified straddle.[360] Any loss with respect to an identified position that is part of an identified straddle cannot otherwise be taken into account by the taxpayer or any other person to the extent that the loss increases the basis of any identified positions that offset the loss position in the identified straddle.

In addition, the provision provides authority to issue Treasury regulations that would specify: (1) the proper methods for clearly identifying a straddle as an identified straddle (and identifying positions as positions in an identified straddle); (2) the application of the identified straddle rules for a taxpayer that fails to properly identify the positions of an identified straddle;[361] and (3) provide an ordering rule for dispositions of less than an entire position that is part of an identified straddle.

The bill also clarifies the present-law straddle rules with respect to taxpayers that settle a position that is part of a straddle by delivering property to which the position relates. Specifically, the provision clarifies that the present-law straddle loss deferral rules treat as a two-step transaction the physical settlement of a straddle position that, if terminated, would result in

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[359] However, to the extent provided by Treasury regulations, taxpayers are not permitted to identify offsetting positions of a straddle if the fair market value of the straddle position already held by the taxpayer at the creation of the straddle is less than its adjusted basis in the hands of the taxpayer.

[360] For this purpose, "unrecognized gain" is the excess of the fair market value of an identified position that is part of an identified straddle at the time the taxpayer incurs a loss with respect to another identified position in the identified straddle, over the fair market value of such position when the taxpayer identified the position as a position in the identified straddle.

[361] For example, although the provision does not require taxpayers to identify any positions of a straddle as an identified straddle, it may be necessary to provide rules requiring all balanced offsetting positions to be included in an identified straddle if a taxpayer elects to identify any of the offsetting positions as an identified straddle.

the realization of a loss. With respect to the physical settlement of such a position, the taxpayer is treated as having terminated the position for its fair market value immediately before the settlement. The taxpayer then is treated as having sold at fair market value the property used to physically settle the position.

The bill also eliminates the exceptions from the straddle rules for stock and qualified covered call options. Thus, offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle if holding one of the positions results in a substantial diminution of the taxpayer's risk of loss with respect to holding the other position.

Effective Date

The provision is effective for positions established on or after the date of enactment.

5. Denial of installment sale treatment for all readily tradable debt (sec. 465 of the bill and sec. 453 of the Code)

Present Law

Under present law, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[362] However, the installment method is not available if the taxpayer sells property in exchange for a readily tradable evidence of indebtedness that is issued by a corporation or a government or political subdivision.[363]

No similar provision under present law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

Reasons for Change

The Committee believes that the present-law exception from the installment method for dispositions of property in exchange for readily tradable debt is too narrow in scope and, in general, should be extended to apply to all dispositions in exchange for readily tradable debt, regardless of the nature of the issuer of such debt.

Explanation of Provision

The provision denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable under present-law rules, regardless of the

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[362] Sec. 453.

[363] Sec. 453(f)(3). Instead, the receipt of such indebtedness is treated as a receipt of payment.

nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

Effective Date

The provision is effective for sales occurring on or after date of enactment.

6. Modify treatment of transfers to creditors in divisive reorganizations (sec. 466 of the bill and secs. 357 and 361 of the Code)

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a controlled subsidiary ("controlled") tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the controlled corporation that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under section 355 and that are considered 'acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

Reasons for Change

The Committee is concerned that taxpayers engaged in section 355 transactions can effectively avoid the rules that require gain recognition if the controlled corporation assumes liabilities of the transferor that exceed the basis of the assets transferred to such corporation. This could occur because of the rules of section 361(b), which state that the transferor can receive money or other property from the transferee without gain recognition, so long as the money or property is distributed to creditors of the transferor. For example, a transferor corporation could receive money from the transferee corporation (e.g., money obtained from a borrowing by the transferee) and use that money to pay the transferor's creditors, without gain recognition. Such a transaction is economically similar to the actual assumption by the transferee of the transferor's liabilities, but is taxed differently under present law because section 361(b) does not contain a limitation on the amount that can be distributed to creditors.

The Committee also believes that it is appropriate to liberalize the treatment of acquisitive reorganizations that are included under section 368(a)(1)(D). The Committee believes that in these cases, the transferor should be permitted to assume liabilities of the transferee without application of the rules of section 357(c). This is because in an acquisitive reorganization under section 368(a)(1)(D), the transferor must generally transfer substantially all its assets to the acquiring corporation and then go out of existence. Assumption of its liabilities by the acquiring corporation thus does not enrich the transferor corporation, which ceases to exist and whose liability was limited to its assets in any event, by corporate form. The Committee believes that it is appropriate to conform the treatment of acquisitive reorganizations under section 368(a)(1)(D) to that of other acquisitive reorganizations.

Explanation of Provision

The bill limits the amount of money plus the fair market value of other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the bill provides that acquisitive reorganizations under section 368(a)(1)(D) are no longer subject to the liabilities assumption rules of section 357(c).

Effective Date

The bill is effective for transactions on or after the date of enactment.

7. Clarify definition of nonqualified preferred stock (sec. 467 of the bill and sec. 351(g) of the Code)

Present Law

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. For this purpose, preferred stock is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

Reasons for Change

The Committee is concerned that taxpayers may attempt to avoid characterization of an instrument as nonqualified preferred stock by including illusory participation rights or including terms that taxpayers argue create an “unlimited” dividend.

Clarification is desirable to conserve IRS resources that otherwise might have to be devoted to this area.

Explanation of Provision

The provision clarifies the definition of nonqualified preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

As one example, instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred stockholders. As another example, stock that entitles the holder to a dividend that is the greater of 7 percent or the dividends common shareholders receive does not avoid being preferred stock if the common shareholders are not expected to receive dividends greater than 7 percent.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective Date

The provision is effective for transactions after May 14, 2003.

8. Modify definition of controlled group of corporations (sec. 468 of the bill and sec. 1563 of the Code)

Present Law

Under present law, a tax is imposed on the taxable income of corporations. The rates are as follows:

Table 2.–Marginal Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
\$0 - \$50,000	15 percent of taxable income
\$50,001 - \$75,000	25 percent of taxable income
\$75,001 - \$10,000,000	34 percent of taxable income
Over \$10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between \$100,000 and \$335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between \$15 million and \$18,333,333.

The component members of a controlled group of corporations are limited to one amount in each of the taxable income brackets shown above.[364] For this purpose, a controlled group of corporations means a parent-subsidiary controlled group and a brother-sister controlled group.

A brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all stock, and (2) more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

Reasons for Change

The Committee is concerned that taxpayers may be able to obtain benefits, such as multiple lower-bracket corporate tax rates, through the use of corporations that are effectively under common control even though the 80-percent test of present law is not satisfied. The Committee believes it is appropriate to eliminate the 80-percent test for purposes of the currently effective provisions under section 1561 (corporate tax brackets, the accumulated earnings credit, and the minimum tax.)

Explanation of Provision

Under the provision, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of all stock, taking into account the

[364] Component members are also limited to one alternative minimum tax exemption and one accumulated earnings credit.

stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

The provision applies only for purposes of section 1561, currently relating to corporate tax brackets, the accumulated earnings credit, and the minimum tax. The provision does not affect other Code sections or other provisions that utilize or refer to the section 1563 brother-sister corporation controlled group test for other purposes.[365]

Effective Date

The provision applies to taxable years beginning after the date of enactment.

9. Mandatory basis adjustments in connection with partnership distributions and transfers of partnership interests (sec. 469 of the bill and secs. 734, 743 and 754 of the Code)

Present Law

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[366] If an election is in effect, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[367] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 is in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[368] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any

[365] As one example, the provision does not change the present law standards relating to deferred compensation, contained in subchapter D of the Code, that refer to section 1563.

[366] Sec. 743(a).

[367] Sec. 743(b).

[368] Sec. 731(a) and (b).

money distributed in the transaction).[369] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[370]

The determination of the basis of individual properties distributed by a partnership is dependent on the adjusted basis of the properties in the hands of the partnership.[371] If a partnership interest is transferred to a partner and the partnership has not elected to adjust the basis of partnership property, a special basis rule provides for the determination of the transferee partner's basis of properties that are later distributed by the partnership.[372] Under this rule, in determining the basis of property distributed by a partnership within 2 years following the transfer of the partnership interest, the transferee may elect to determine its basis as if the partnership had adjusted the basis of the distributed property under section 743(b) on the transfer. The special basis rule also applies to distributed property if, at the time of the transfer, the fair market value of partnership property other than money exceeds 110 percent of the partnership's basis in such property and a liquidation of the partnership interest immediately after the transfer would have resulted in a shift of basis to property subject to an allowance of depreciation, depletion or amortization.[373]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[374] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[375] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

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[369] Sec. 732(b).

[370] Sec. 732(a).

[371] Sec. 732 (a)(1) and (c).

[372] Sec. 732(d).

[373] Treas. Reg. 1.732-1(d)(4).

[374] Sec. 734(a).

[375] Sec. 734(b).

Reasons for Change

The Committee believes that the present-law electivity of partnership basis adjustments upon transfers and distributions leads to anomalous tax results, causes inaccurate income measurement, and gives rise to opportunities for tax sheltering. In particular, the failure to make partnership basis adjustments permits partners to duplicate losses and to transfer losses among partners, creating an inappropriate incentive to use partnerships as tax shelter vehicles. The electivity of these adjustments has become anachronistic and should be eliminated, the Committee believes. Therefore, this provision makes these partnership basis adjustments mandatory, addressing both loss and gain situations. The bill provides that the partnership basis adjustments remain elective in the limited case of transfers of a partnership interest by reason of the death of a partner because that situation may involve unsophisticated taxpayers and constitutes only a narrow, limited set of transfers.

Explanation of Provision

Under the provision, adjustments to the basis of partnership property in the event of a partnership distribution or the transfer of a partnership interest are required, not elective as under present law. However, the basis adjustments are elective, as under present law, in the case of the transfer of a partnership interest by reason of the partner's death. Any election made by a partnership under section 754 that is in effect when the provision becomes effective is treated as an election to adjust the basis of partnership property with respect to the transferee partner in the case of a transfer of a partnership interest upon the death of a partner. The provision repeals the special rule of section 732(d) for determining the transferee partner's basis in property that is later distributed by the partnership in cases in which the partnership did not have a section 754 election in effect with respect to the transfer of the partnership interest.

Effective Date

The provision requiring partnership basis adjustments applies to transfers and distributions after the date of enactment.

The provision repealing section 732(d) applies generally to transfers after the date of enactment, except that it applies to distributions made after the date which is 2 years following the date of enactment in the case of any transfer to which section 732(d) applies that is made on or before the date of enactment.

10. Extend the present-law intangible amortization provisions to acquisitions of sports franchises (sec. 471 of the bill and sec. 197 of the Code)

Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[376] These rules were enacted in 1993 to minimize disputes

[376] Sec. 197.

regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[377] However, other special rules apply to certain of these intangible assets.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[378] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

In general, section 1245 provides that gain from the sale of certain property is treated as ordinary income to the extent depreciation or amortization was allowed on such property. Section 1245(a)(4) provides special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply in the case of the sale, exchange, or other disposition of a sports franchise. Under the special recapture rules, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise.

Reasons for Change

The present-law rules under section 197 were enacted to minimize disputes regarding the measurement of acquired intangible assets. Prior to the enactment of the rules, there were many disputes regarding the value and useful life of various intangible assets acquired together in a business acquisition. Furthermore, in the absence of a showing of a reasonably determinable useful life, an asset could not be amortized. Taxpayers tended to identify and allocate large amounts of purchase price to assets said to have short useful lives, while the IRS would allocate a large amount of value to intangible value for which no determinable useful life could be shown (e.g., goodwill), and would deny amortization for that amount of purchase price.

The present-law rules for acquisitions of sports franchises do not eliminate the potential for disputes, because they address only player contracts, while a sports franchise acquisition can involve many intangibles other than player contracts. In addition, disputes may arise regarding the appropriate period for amortization of particular player contracts. The Committee believes expending taxpayer and government resources disputing these items is an unproductive use of

[377] Sec. 197(e)(6).

[378] *P.D.B. Sports, Ltd. v. Comm.*, 109 T.C. 423 (1997).

economic resources. The Committee further believes that the section 197 rules should apply to all types of businesses regardless of the nature of their assets.

Explanation of Provision

The provision extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with the acquisition of such a franchise (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises. The provision also repeals the special rules under section 1245(a)(4) and makes other conforming changes.

Effective Date

The provision is effective for property acquired after the date of enactment. The amendment to section 1245(a)(4) applies to franchises acquired after the date of enactment.

11. Lease term to include certain service contracts (sec. 472 of the bill and sec. 168 of the Code)

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[379] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[380] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[381]

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

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[379] Sec. 168(g)(3)(A).

[380] Sec. 168(h)(1).

[381] Sec. 168(h)(2).

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Reasons for Change

The special rules applicable to the depreciation of tax-exempt use property were enacted to prevent tax-exempt entities from using leasing arrangements to transfer the tax benefits of accelerated depreciation on property they used to a taxable entity. The Committee is concerned that some taxpayers are attempting to circumvent this policy through the creative use of service contracts with the tax-exempt entities.

Explanation of Provision

The provision expands the definition of a lease to include service contracts and other similar arrangements and requires lessors of tax-exempt use property to include the term of service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

Effective Date

The proposal is effective for leases and other similar arrangements entered into after the date of enactment. No inference is intended with respect to the tax treatment of leases and other similar arrangements entered into before such date.

12. Establish specific class lives for utility grading costs (sec. 473 of the bill and sec. 168 of the Code)

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[382] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. Assets class 00.3 provides a class life of 20 years and a MACRS recovery period of 15 years for land improvements. The cost of initially clearing and grading land improvements are

[382] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

specifically excluded from asset classes 00.3 and 49.14. Prior to the adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as section 1245 real property for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from this asset class as well as asset class 00.3, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as section 1245 real property for which no class life is provided.

Reasons for Change

The Committee believes the clearing and grading costs in question are incurred for the purpose of installing the transmission lines or pipelines and are properly seen as part of the cost of installing such lines or pipelines and their cost should be recovered in the same manner. The clearing and grading costs are not expected to have a useful life other than the useful life of the transmission line or pipeline to which they relate.

Explanation of Provision

The provision assigns a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The provision includes these assets in the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective Date

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

13. Expansion of limitation on expensing of certain passenger automobiles (sec. 474 of the bill and sec. 179 of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over five years. However, section 280F limits the annual depreciation deduction with respect to certain passenger automobiles.[383]

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[384] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sports utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment (sec. 179). The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[385] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[386] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.

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[383] The limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles (subject to the such limitation) placed in service in 2002, the maximum amount of allowable depreciation is $7,660 for the year in which the vehicle was placed in service, $4,900 for the second year, $2,950 for the third year, and $1,775 for the fourth and later years. This limitation applies to the combined depreciation deduction provided under present law for depreciation, including section 179 expensing and the temporary 30 percent additional first year depreciation allowance. For luxury automobiles eligible for the 50% additional first depreciation allowance, the first year limitation is increased by an additional $3,050.

[384] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

[385] Pub. Law No. 108-27, sec. 202 (2003).

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

Reasons for Change

The Committee believes that section 179 expensing provides two important benefits for small business. First, it lowers the cost of capital for property used in a trade or business. With a lower cost of capital, the Committee believes small business will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. However, the Committee understands that some taxpayers are using section 179 to lower the cost of purchasing certain types of vehicles (1) that are not subject to the luxury automobile limitations imposed by Congress and (2) for which the specific features of such vehicle are not necessary for purposes of conducting the taxpayer's business. The Committee is concerned about such market distortions and does not believe that the United States taxpayers should subsidize a portion of such purchase. The Committee's provision places new restrictions on the ability of certain vehicles to qualify for the expensing provisions of section 179.

Explanation of Provision

The provision limits the ability of taxpayers to claim deductions under section 179 for certain vehicles not subject to section 280F to $25,000. The provision applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the present law 6,000 pound rating). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) does not have a primary load device or container attached; (2) has a seating capacity of more than 12 individuals; (3) is designed for more than nine individuals in seating rearward of the driver's seat; (4) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least 72.0 inches in interior length; or (5) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The following example illustrates the operation of the provision.

Example.–Assume that during 2004, a calendar year taxpayer acquires and places in service a sport utility vehicle subject to the provision that costs $70,000. In addition, assume that the property otherwise qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $25,000 deduction under section 179. The taxpayer is also allowed an additional first-year depreciation deduction (sec. 168(k)) of $22,500 based on $45,000 ($70,000 original cost less the section 179 deduction of $25,000) of adjusted basis. Finally, the remaining adjusted basis of $22,500 ($45,000 adjusted basis less $22,500 additional first-year depreciation) is eligible for an additional depreciation deduction of $4,500 under the general depreciation rules (automobiles are five-year recovery property). The remaining $18,000 of cost ($70,000 original cost less $52,000 deductible currently) would be recovered in 2005 and subsequent years pursuant to the general depreciation rules.

Effective Date

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

14. Provide consistent amortization period for intangibles (sec. 475 of the bill and secs. 195, 248, and 709 of the Code)

Present Law

At the election of the taxpayer, start-up expenditures[387] and organizational expenditures[388] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[389] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

Reasons for Change

The Committee believes that allowing a fixed amount of start-up and organizational expenditures to be deductible, rather than requiring their amortization, may help encourage the formation of new businesses that do not require significant start-up or organizational costs to be incurred. In addition, the Committee believes a consistent amortization period for intangibles is appropriate.

Explanation of Provision

The provision modifies the treatment of start-up and organizational expeditures. A taxpayer would be allowed to elect to deduct up to $5,000 of start-up and $5,000 of

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387 Sec. 195

388 Secs. 248 and 709.

389 Treas. Reg. sec. 1.195-1.

organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective Date

The provision is effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

15. Limitation of tax benefits for leases to certain tax exempt entities (sec. 476 of the bill and new sec. 470 of the Code)

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[390] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[391] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[392]

In determining the length of the lease term for purposes of the 125 percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

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[390] Sec. 168(g)(3)(A).

[391] Sec. 168(h)(1).

[392] Sec. 168(h)(2).

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Reasons for Change

The Committee believes that certain ongoing leasing activity with tax-exempt entities and foreign governments highlights the potential ineffectiveness of the present-law tax rules that are intended to limit the ability to transfer certain tax benefits from a tax exempt entity to a taxable entity. The Committee is concerned about this activity and the continual development of new structures by tax shelter promoters that purport to minimize or neutralize the effect of these rules. In addition, the Committee also is concerned by the increasing use of certain lease structures involving technological equipment that it does not view as appropriate. Although the Committee considers leasing to play a role in ensuring the availability of capital to businesses, many of the transactions it recently has become aware of are not the type of activity that it believes play this role. Rather these transactions may result in no accumulation of capital for financing or refinancing, but only a tax accommodation fee paid by a U.S. taxpayer to a tax indifferent party.

In discussing the reasons for the enactment of rules in 1984 that were intended to limit the transfer of tax benefits with respect to property used by tax-exempt entities to taxable entities, Congress indicated at that time that it: (1) believed tax benefits (in excess of tax exemption itself) available to tax-exempt entities through leasing should be eliminated; (2) was concerned about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clientele, if substantial amounts of their property came under the control of outside parties solely because the Federal tax system made leasing more favorable than owning; (3) believed the tax system should not encourage tax-exempt entities to dispose of assets they own or to forego control over the assets they use; (4) was concerned about waste of Federal revenues because in some cases a substantial portion of the tax savings was retained by the lawyers, investment bankers, lessors, and investors, and thus, the Federal revenue loss became more of a gain to financial entities than to tax-exempt entities; (5) was more efficient to provide aid to tax-exempt entities through direct appropriations rather than through the tax code; (6) must sustain a popular confidence in the tax system by ensuring the system generally is working correctly, and that a system enticing Federal agencies not to own their own essential equipment, or colleges their campuses, or cities their city halls, and which also rewards taxpayers who participate in such transactions with a lighter tax burden, risked eroding that confidence.[393]

The Committee believes that the reasons stated above are as important today as they were in 1984 and that, unfortunately, the present law rules have not stopped taxpayers from engaging in transactions that purport to circumvent such rules. New legislation therefore is essential to ensure the attainment of the aforementioned Congressional intentions.

[393] *See,* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), pg. 43-46, December 31, 1984.

Explanation of Provision

The provision limits the amount of allowable deductions or losses[394] with respect to certain service contracts or leases to the amount of income reported with respect to each such service contract or lease in such taxable year.[395] The provision applies to leases and certain service contracts and similar arrangements with a tax-exempt entity. For purposes of the provision a tax-exempt entity is defined as the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing; an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter one of the Code; and any foreign government, political subdivision thereof, or any agency or instrumentality of any of the foregoing.

Any deduction disallowed is carried forward and treated as a deduction with respect to such property in the next taxable year. If property ceases to be tax-exempt use property, any unused deduction is allowable as a deduction only to the extent of any net income allocable to such property. In addition, a taxpayer disposing of its entire interest in tax-exempt use property in a fully taxable transaction is generally entitled to deduct any items previously disallowed (and not subsequently allowed) in the year of such disposition.[396] The provision also grants the Treasury Department authority to prescribe regulations as may be necessary or appropriate to carryout the provisions of this section.[397]

Effective Date

The provision is effective for leases and other similar arrangements entered into after the date of enactment.

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[394] The provision applies to any deduction directly allocable to any tax-exempt use property and a proper share of other deductions that are not directly allocable to such property (e.g., interest expense not directly allocable, general overhead, etc.).

[395] It is intended that the limitations would be similar in concept to the limitations imposed on passive activity losses under section 469 and, in particular, subsection (k) (e.g., each tax-exempt use property is treated separately). This provision applies to all taxpayers (including C corporations) and the limitation applies under all circumstances (e.g., material participation is not relevant).

[396] Rules similar to the rules of section 469(g) shall apply for this purpose.

[397] For example, regulations would be appropriate to ensure that the provision applies to a transaction in which a foreign government (or other tax exempt entity) transfers an interest in property to an accommodation party (e.g., non governmental foreign person) who subsequently enters into a sale/leaseback of such property with a U.S. taxpayer.

16. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 481 of the bill and sec. 338 of the Code)

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15^{th} day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

Reasons for Change

The Committee is concerned that some taxpayers may inappropriately be taking the position that estimated tax and the penalty (computed in the amount of an interest charge) under section 6655 applies neither to the stock sale nor to the asset sale in the case of a section 338(h)(10) election. The Committee believes that estimated tax should not be avoided merely because an election may be made under section 338(h)(10). Furthermore, the Committee understands that parties typically negotiate a sale with an understanding as to whether or not an election under section 338(h)(10) will be made. In the event there is a contingency in this regard, the parties may provide for adjustments to the price to reflect the effect of the election.

Explanation of Provision

The bill clarifies section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the bill if a qualified stock purchase transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed based on an asset sale, computed from the date of the sale.

If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on the stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

Effective Date

The bill is effective for qualified stock purchase transactions that occur after the date of enactment.

17. Extension of IRS user fees (sec. 482 of the bill and sec. 7529 of the Code)

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[398] Public Law 108-89[399] extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.[400]

Reasons for Change

The Committee believes that it is appropriate to provide a further extension of these user fees.

Explanation of Provision

The bill extends the statutory authorization for these user fees through September 30, 2013.

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[398] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987). Public Law 104-117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)) extended the statutory authorization for these user fees through September 30, 2003.

[399] 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

[400] That Public Law also moved into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, June 7, 2001).

Effective Date

The provision is effective for requests made after the date of enactment.

18. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 483 of the bill)

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related and fraud penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the same statute of limitations.

Delinquency penalties

Failure to file.–Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay.–Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax.–The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the day on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

The accuracy-related penalty is imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax and (3) any substantial valuation misstatement. In addition, the penalty is doubled for certain gross valuation misstatements. These consolidated penalties are also coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. However, Treasury has issued proposed regulations that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

Negligence or disregard for the rules or regulations.–If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless or intentional disregard of the rules or regulations.

Substantial understatement of income tax.–Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement.–A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Gross valuation misstatements.–The rate of the accuracy-related penalty is doubled (to 40 percent) in the case of gross valuation misstatements.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Interest Provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. Taxpayers eligible under OVCI will not be liable for civil fraud, the fraudulent failure to file penalty or the civil information return penalties. The taxpayer will pay back taxes, interest and certain accuracy-related and delinquency penalties.

Voluntary Disclosure Initiative

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers

Reasons for Change

The Committee is aware that individuals and corporations, through sophisticated transactions, are placing unreported income in offshore financial accounts accessed through credit or debit cards or other financial arrangements in order to avoid or evade Federal income tax. Such a phenomenon poses a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system. The IRS estimates there may be several hundred thousand taxpayers using offshore financial arrangements to conceal taxable income from the IRS costing the government billions of dollars in lost revenue. Under the OVCI initiative, only 1,253 taxpayers from 46 states stepped forward to participate in the program. From these cases, the IRS expects to identify millions of dollars of uncollected tax. At the start of the program, the clear message to taxpayers was that those who failed to come forward would be pursued by the IRS and would be subject to more significant penalties and possible criminal sanctions. The Committee believes that doubling the civil penalties, fines and interest applicable to taxpayers who entered in to these arrangements and did not take advantage of OVCI will provide the IRS with the significant sanctions needed to stem the promotion of, and participation in, these abusive schemes.

Explanation of Provision

The provision increases by a factor of two the total amount of civil penalties, interest and fines applicable for taxpayers who would have been eligible to participate in either the OVCI or the Treasury Department's voluntary disclosure initiative (which applies to the taxpayer by reason of the taxpayer's underpayment of U.S. income tax liability through certain financing arrangements) but did not participate in either program.

Effective Date

The provision generally is effective with respect to a taxpayer's open tax years on or after date of enactment.

19. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 484 of the bill and sec. 6159 of the Code)

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

Reasons for Change

The Committee believes that clarifying that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement will improve effective tax administration.

The Committee recognizes that some taxpayers are unable or unwilling to enter into a realistic offer in compromise. The Committee believes that these taxpayers should be encouraged to make partial payments toward resolving their tax liability, and that providing for partial payment installment agreements will help facilitate this. The Committee also believes, however, that the offer in compromise program should remain the sole avenue via which taxpayers fully resolve their tax liabilities and attain a fresh start.

Explanation of Provision

The provision clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The provision also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Effective Date

The provision is effective for installment agreements entered into on or after the date of enactment.

20. Extension of customs user fees (sec. 485 of the bill)

Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 108-89 which extended authorization for the collection of these fees through March 31, 2004.[401]

Reasons for Change

The Committee believes it is important to extend these fees to cover the expenses of the services provided.

Explanation of Provision

The bill extends the passenger and conveyance processing fees and the merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2013.

[401] Sec. 301; 117 Stat. 1131.

Effective Date

The provisions are effective upon the date of enactment.

21. Deposits made to suspend the running of interest on potential underpayments (sec. 486 of the bill and new sec. 6603 of the Code)

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

Reasons for Change

The Committee believes that an improved deposit system that allows for the payment of interest on amounts that are not ultimately needed to offset tax liability when the taxpayer's position is upheld, as well as allowing for the offset of tax liability when the taxpayer's position fails, will provide an effective way for taxpayers to manage their exposure to underpayment interest. However, the Committee believes that such an improved deposit system should be reserved for the issues that are known to both parties, either through IRS examination or voluntary taxpayer disclosure.

Explanation of Provision

In general

The bill allows a taxpayer to deposit cash with the IRS that may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is deposited for the period that the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Withdrawal of amounts

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Thus, the interest received on withdrawn deposits will not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

Effective Date

The provision applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

22. Qualified tax collection contracts (sec. 487 of the bill and new sec. 6306 of the Code)

Present Law

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes.[402] The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[403] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot. The pilot program results were disappointing because "IRS' efforts to design and implement the private debt collection pilot program were hindered by limitations that affected the program's results." The limitations included the scope of work permitted to the private debt collection companies, the number and type of cases referred to the private debt collection companies, and the ability of IRS' computer systems to identify, select, and transmit collection cases to the private debt collectors.

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[404]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[405] That provision does not apply to the collection of debts under the Internal Revenue Code.[406]

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[402] Sec. 7801(a).

[403] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

[404] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.

[405] 31 U.S.C. sec. 3718.

[406] 31 U.S.C. sec. 3718(f).

On February 3, 2003, the President submitted to the Congress his fiscal year 2004 budget proposal,[407] which proposed the use of private debt collection companies to collect Federal tax debts.

Reasons for Change

The Committee believes that the use of private debt collection agencies will help facilitate the collection of taxes that are owed to the Government. The Committee also believes that the safeguards it has incorporated will protect taxpayers' rights and privacy.

Explanation of Provision

The bill permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities[408] of any type[409] and to arrange payment of those taxes by the taxpayers. Several steps are involved. First, the private debt collection company contacts the taxpayer by letter.[410] If the taxpayer's last known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[411] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as three years. If the taxpayer is unable to pay the outstanding tax liability in full over a three-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

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[407] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004* (H. Doc. 108-3, Vol. I), p. 274.

[408] There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability.

[409] The bill generally applies to any type of tax imposed under the Internal Revenue Code. It is anticipated that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[410] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to 6103 is necessary to implement the provision. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

[411] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

The bill specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees are also made statutorily applicable to employees of private sector debt collection companies. Third, the private sector debt collection companies are required to inform taxpayers of the availability of assistance from the Taxpayer Advocate. Fourth, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS.

The bill creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The bill prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[412]

Effective Date

The provision is effective on the date of enactment.

23. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 491 of the bill and sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[413] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

[412] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.

[413] Sec. 4131.

Reasons for Change

The Committee is aware that the Centers for Disease Control and Prevention have recommended that children in 17 highly endemic States be inoculated with a hepatitis A vaccine. The population of children in the affected States exceeds 20 million. Several of the affected States mandate childhood vaccination against hepatitis A. The Committee is aware that the Advisory Commission on Childhood Vaccines has recommended that the vaccine excise tax be extended to cover vaccines against hepatitis A. For these reasons, the Committee believes it is appropriate to include vaccines against hepatitis A as part of the Vaccine Injury Compensation Program. Making the hepatitis A vaccine taxable is a first step.[414] In the unfortunate event of an injury related to this vaccine, families of injured children are eligible for the no-fault arbitration system established under the Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

Explanation of Provision

The bill adds any vaccine against hepatitis A to the list of taxable vaccines. The bill also makes a conforming amendment to the trust fund expenditure purposes.

Effective Date

The provision is effective for vaccines sold and used beginning on the first day of the first month beginning more than four weeks after the date of enactment.

24. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 492 of the bill and sec. 121 of the Code)

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[415] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

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[414] The Committee recognizes that, to become covered under the Vaccine Injury Compensation Program, the Secretary of Health and Human Services also must list the hepatitis A vaccine on the Vaccine Injury Table.

[415] Sec. 121.

Reasons for Change

The Committee strongly believes that the present-law exclusion of gain allowable upon the sale or exchange of principal residences serves an important role in encouraging home ownership. The Committee does not believe that this exclusion is appropriate for properties that were recently acquired in like-kind exchanges. Under the like-kind exchange rules, a taxpayer that exchanges property that was held for productive use or investment for like-kind property may acquire the replacement property on a tax-free basis. Because the replacement property generally has a low carry-over tax basis, the taxpayer will have taxable gain upon the sale or exchange of the replacement property. However, when the taxpayer converts the replacement property into the taxpayer's principal residence, the taxpayer may shelter some or all of this gain from income taxation. The Committee believes that this proposal balances the concerns associated with these provisions to reduce this tax shelter concern without unduly limiting the exclusion on sales or exchanges of principal residences.

Explanation of Provision

The bill provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

Effective Date

The provision is effective for sales or exchanges of principal residences after the date of enactment.

25. Modify qualification rules for tax-exempt property and casualty insurance companies (sec. 493 of the bill and secs. 501(c)(15) and 831(b) of the Code)

Present Law

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshhold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

Reasons for Change

The Committee has become aware of abuses in the area of tax-exempt insurance companies. Considerable media attention has focused on the inappropriate use of tax-exempt insurance companies to shelter investment income.[416] The Committee believes that the use of these organizations as vehicles for sheltering income was never contemplated by Congress. The proliferation of these organizations as a means to avoid tax on income, sometimes on large investment portfolios, is inconsistent with the original narrow scope of the provision, which has been in the tax law for decades. The Committee believes it is necessary to limit the availability of tax-exempt status under the provision so that it cannot be abused as a tax shelter. To that end, the bill applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts.

The bill correspondingly expands the availability of the present-law election of a property and casualty insurer to be taxed only on taxable investment income to companies with premiums below $350,000. This provision of present law provides a relatively simple tax calculation for small property and casualty insurers, and because the election results in the taxation of investment income, the Committee does not believe that it is abused to avoid tax on investment income. Thus, the bill provides that a company whose net written premiums (or if greater, direct written premiums) do not exceed $1.2 million (without regard to the $350,000 threshhold of present law) is eligible for the simplification benefit of this election.

Explanation of Provision

The provision modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Under the provision, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account. The provision expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the bill. For this purpose, the term “insurance company” means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a) and new sec. 831(c)). A company whose investment activities outweigh

[416] See David Cay Johnston, *Insurance Loophole Helps Rich,* N.Y. Times, April 1, 2003; David Cay Johnston, *Tiny Insurers Face Scrutiny as Tax Shields,* N.Y. Times, April 4, 2003, at C1; Janet Novack, *Are You a Chump?,* Forbes, Mar. 5, 2001.

its insurance activities is not considered to be an insurance company for this purpose.[417] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

The provision also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (without regard to whether such premiums exceed $350,000) (sec. 831(b)). As under present law, for purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the provision, including, for example, by attempts to characterize as premiums any income that is other than premium income.

Effective Date

The provisions are effective for taxable years beginning after December 31, 2003.

26. Definition of insurance company for property and casualty insurance company tax rules (sec. 494 of the bill and sec. 831(c) of the Code)

Present Law

Present law provides specific rules for taxation of the life insurance company taxable income of a life insurance company (sec. 801), and for taxation of the taxable income of a company other than a life insurance company (sec. 831) (generally referred to as a property and casualty insurance company). For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applicable to life insurance companies explicitly defines the term "insurance company" to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)).

The life insurance company statutory definition of an insurance company does not explicitly apply to property and casualty insurance companies, although a long-standing Treasury regulation[418] that is applied to property and casualty companies provides a somewhat similar

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[417] *See, e.g.*, *Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).

[418] The Treasury regulation provides that "the term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company

definition of an "insurance company" based on the company's "primary and predominant business activity."[419]

When enacting the statutory definition of an insurance company in 1984, Congress stated, "[b]y requiring [that] more than half rather than the 'primary and predominant business activity' be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies . . . Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities."[420]

Reasons for Change

The Committee believes that the law will be made clearer and more exact and tax administration will be improved by conforming the definition of an insurance company for

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is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. section 1.801-3(a)(1).

[419] Court cases involving a determination of whether a company is an insurance company for Federal tax purposes have examined all of the business and other activities of the company. In considering whether a company is an insurance company for such purposes, courts have considered, among other factors, the amount and source of income received by the company from its different activities. *See Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182 (1932); *United States v. Home Title Insurance Co.*, 285 U.S. 191 (1932). *See also Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), in which the court concluded that the company was not an insurance company: "The ... financial data clearly indicates that petitioner's primary and predominant source of income was from its investments and not from issuing insurance contracts or reinsuring risks underwritten by insurance companies. During each of the years in issue, petitioner's investment income far exceeded its premiums and the amounts of earned premiums were de minimis during those years. It is equally as clear that petitioner's primary and predominant efforts were not expended in issuing insurance contracts or in reinsurance. Of the relatively few policies directly written by petitioner, nearly all were issued to [family members]. Also, Investment Life, in which [family members] each owned a substantial stock interest, was the source of nearly all of the policies reinsured by petitioner. These facts, coupled with the fact that petitioner did not maintain an active sales staff soliciting or selling insurance policies . . ., indicate a lack of concentrated effort on petitioner's behalf toward its chartered purpose of engaging in the insurance business. . . . For the above reasons, we hold that during the years in issue, petitioner was not 'an insurance company . . . engaged in the business of issuing life insurance' and hence, that petitioner was not a life insurance company within the meaning of section 801." 56 T.C. 497, 507-508.

[420] H.R. Rep. 98-432, part 2, at 1402-1403 (1984); S. Prt. No. 98-169, vol. I, at 525-526 (1984); *see also* H.R. Rep. No. 98-861 at 1043-1044 (1985) (Conference Report).

purposes of the property and casualty insurance tax rules to the existing statutory definition of an insurance company under the life insurance company tax rules. Further, the Committee expects that IRS enforcement activities to prevent abuse of the provision relating to tax-exempt insurance companies will be simplified and improved by this provision of the bill.

Explanation of Provision

The bill provides that, for purposes of determining whether a company is a property and casualty insurance company, the term "insurance company" is defined to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, the bill conforms the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform. The provision adopts a stricter and more precise standard than the "primary and predominant business activity" test contained in Treasury Regulations. A company whose investment activities outweigh its insurance activities is not considered to be an insurance company under the provision.[421] It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income.

Effective Date

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

27. Limit deduction for charitable contributions of patents and similar property (sec. 495 of the bill and secs. 170 and 6050L of the Code)

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[422] The amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

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[421] *See Inter-American Life Insurance Co. v. Comm'r, supra.*

[422] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets.[423]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[424] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[425] In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[426]

In general, charitable organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organization may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. In general, an excess benefit transaction between a public charity and a disqualified person is subject to intermediate sanctions.[427]

Reasons for Change

The Committee believes that in the context of charitable contributions the valuation of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property is highly speculative. In theory, such intellectual property may promise significant monetary benefits, but the benefits will not materialize if the charity does not make the appropriate investments, have the right personnel and equipment, or even have sufficient sustained interest to exploit the intellectual property. In addition, some donated intellectual property may prove to be worthless, or the initial promise of worth may be diminished by future inventions and marketplace competition. The Committee understands that valuation is made yet more difficult in the charitable contribution context

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[423] *See* sec. 1221(a)(3), 1231(b)(1)(C).

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

[425] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

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

[427] Sec. 4958.

because the transferee does not provide full, if any, consideration in exchange for the transferred property pursuant to arm's length negotiations.

The Committee is concerned that taxpayers with patents or similar property are taking advantage of the inherent difficulties in valuing such property and are preparing or obtaining erroneous valuations. In such cases, the charity receives an asset of questionable value, while the taxpayer receives a significant tax benefit. The Committee believes that the excessive charitable contribution deductions enabled by inflated valuations is best addressed by ensuring that the amount of the deduction for charitable contributions of such property may not exceed the taxpayer's basis in the property. The Committee notes that for other types of charitable contributions for which valuation is especially problematic -- charitable contributions of property created by the personal efforts of the taxpayer and charitable contributions to certain private foundations -- a basis deduction generally is the result under present law.

Although the Committee believes that a deduction of basis is appropriate in this context, the Committee recognizes that some contributions of patents or similar property are valuable and that donors may need an economic incentive to continue to make such contributions. Accordingly, the Committee believes that it is appropriate to permit donors of patents and similar property, upon negotiation with the donee, to make a charitable contribution (relinquishing ownership of the property) and have a right to receive certain payments attributable to the contributed property.

Explanation of Provision

In general

The provision provides that the amount of the deduction for charitable contributions of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property ("intellectual property") may not exceed the taxpayer's basis in the contributed property. The provision permits a taxpayer to take such a deduction and have the right to receive certain payments (a "qualified interest") from the donee organization, provided that the donor relinquishes ownership of the entire property. A deduction of the taxpayer's basis in the contributed property is permitted notwithstanding the amount of any benefit or quid pro quo received by the taxpayer in the form of a qualified interest. In cases where the donor has a qualified interest, the provision overrides present-law rules regarding contributions of partial interests and bargain sales to the extent that they otherwise apply. If after a contribution of intellectual property, a taxpayer has any interest other than a qualified interest, no deduction is allowed and any payments received by the donor are taxed under the generally applicable law.

The provision does not change present law rules regarding private inurement, private benefit, or intermediate sanctions. The fact that a right to receive payments meets the statutory standard of a qualified interest does not immunize the contribution from such present-law rules. Accordingly, under the provision, a donor's contribution of intellectual property and right to receive certain payments could, depending on the facts and circumstances, result in impermissible private inurement or private benefit, or be treated as an excess benefit transaction for purposes of intermediate sanctions.

Present law rules regarding substantiation of charitable contributions apply, except that, for contributions of intellectual property by C corporations for which a deduction in excess of $500 is claimed, it is intended that the C corporation state on any return required by the Secretary with respect to the reporting of the contribution whether the fair market value of the contribution exceeds the C corporation's basis in the contributed property, and, in addition, state the fair market value of the contribution but only if such value is less than the C corporation's basis in the contributed property. For purposes of substantiation required of the donee organization for gifts of $250 or more, a qualified interest is not considered the provision of goods or services.

The provision does not change the rules for charitable contributions of intellectual property that under present law generally provide the donor a basis deduction (for example, copyrights described in sections 1221(a)(3) and 1231(b)(1)(C)).

Donor's qualified interest

A qualified interest of a donor is a right to receive payments from the donee organization that are attributable to royalties received by the donee organization with respect to the contributed property. No single payment to the donor by the donee organization may exceed 50 percent of the amount of the correlating royalty received by the donee organization from a third party with respect to the contributed property. The Secretary of the Treasury is authorized to treat as a qualified interest the right to receive other payments from the donee, but only if the donee does not possess a right to receive any payment (whether royalties or otherwise) from a third party with respect to the contributed property. In such a case, the Secretary may not treat as a qualified interest the right to receive any payment that provides a benefit to the donor that is greater than the benefit retained by the donee.[428] In any case, an interest is not a qualified interest if the donor has a right to receive payments after the earlier of the expiration of the legal life of the contributed property or the date that is twenty years after the date of the contribution.[429] A qualified interest does not include a right to receive any portion of proceeds from a sale of the contributed property by the donee.

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[428] For example, in general, if the donee organization uses the contributed property in furtherance of the donee's exempt purposes, the Secretary may determine that it is appropriate to provide guidance that treats as a qualifying interest the right to receive from the donee payments that do not exceed 50 percent of the royalties that could be obtained by the donee if the donee granted a license of the contributed property pursuant to arm's length principles.

[429] The time (the earlier of twenty years or the legal life of the property) and amount (50 percent of royalty payments) limitations are intended as upper limits. It is expected that the donee organization will negotiate with the donor time and percentage limitations that are reasonable with respect to the property contributed, based on factors such as the likelihood of successful development, the maturity of the contributed property at the time of the contribution, and the effort and time likely to be invested by the donee organization in the contributed property.

The provision provides that payments pursuant to a qualified interest will constitute ordinary income recognized by the donor when received, regardless of the donor's method of accounting.

Reporting requirements

Under the provision, the donee organization must file a return with the Secretary for any calendar year during which the donee organization makes a payment pursuant to a qualified interest. The return must show: (1) the name, address, and taxpayer identification number of the payor and the payee with respect to a payment; (2) a description, and date of contribution, of the property to which the qualified interest relates; (3) the dates and amounts of any royalty payments received by the donee with respect to such property; (4) the date and the amount of the payment pursuant to the qualified interest; (5) a description of the terms of the qualified interest; and (6) such other information as the Secretary may prescribe. The donee organization is required to furnish a copy of any such return to the donor of the contributed property to which the qualified interest relates. Generally applicable penalties apply to failures to file such a return or furnish the required information.[430]

Treasury guidance regarding abusive situations

The provision provides the Secretary of the Treasury with the authority to issue regulations or other guidance to prevent avoidance of the purposes of the provision. In general, the provision is intended to prevent taxpayers from claiming a deduction in excess of basis with respect to charitable contributions of intellectual property. A taxpayer would contravene the purposes of the provision, for example, by engaging in transactions or other activity that manipulated the basis of the contributed property or changed the form of the contributed property in order to increase the amount of the deduction. This might occur, for instance, if a taxpayer, for the purpose of claiming a larger deduction, engaged in activity that increased the basis of the contributed property by using related parties, pass-thru entities, or other intermediaries or means. The purpose of the provision also would be abused if a taxpayer changed the form of the property in order to claim a larger deduction by, for example, embedding the property into a product, contributing the product, and claiming a fair market value deduction based in part on the fair market value of the embedded property. In such abusive cases, any guidance issued by the Secretary of the Treasury shall provide that the taxpayer is required to separate the embedded property from the related product and treat the charitable contribution as contributions of distinct properties, with each property subject to the applicable deduction rules.

Effective Date

The provision is effective for contributions made after October 1, 2003.

[430] Secs. 6721-6724.

28. Repeal of ten-percent rehabilitation tax credit (sec. 496 of the bill and sec. 47(a)(1) of the Code)

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures (sec. 47).

A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, the building must have been substantially rehabilitated, and it must have been placed in service before the beginning of the rehabilitation. A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

Reasons for Change

The Committee believes that the rehabilitation credit would be simplified by repealing the 10-percent credit while retaining the 20-percent credit. The category of non-historic structures under the 10-percent credit has an increasing potential overlap with the category of certified historic structures under the 20-percent credit, and the two-tier format of the credit creates needless complexity. Therefore, the Committee bill repeals the 10-percent rehabilitation credit with respect to buildings first placed in service before 1936.

Explanation of Provision

The provision repeals the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936. The provision retains the present-law 20-percent credit for rehabilitation expenditures with respect to a certified historic structure.

Effective Date

The provision is effective for expenditures incurred in taxable years beginning after December 31, 2003.

29. Increase age limit under section 1(g) (sec. 497 of the bill and sec. 1 of the Code)

Present Law

Filing requirements for children

A single unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income only over $4,750 (for 2003); (2) unearned income only over the minimum standard deduction amount for dependents ($750 in 2003); or (3) both earned income and unearned income totaling more than the smaller of (a) $4,750 (for 2003) or (b) the larger of (i) $750 (for 2003), or (ii) earned income plus $250.[431] Thus, if a dependent child has less than $750 in gross income, the child does not have to file an individual income tax return for 2003.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income under section 1(g)

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[432] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year; (2) the child's investment income was more than $1,500 (for 2003); and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($750 for 2003), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized

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[431] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 3, Table 1 (2002).

[432] Sec. 1(g).

deductions that are directly connected with the production of the unearned income.[433] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[434]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's unearned income

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[435]

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[433] Sec. 1(g)(4).

[434] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 6 (2002).

[435] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2002).

(2) such income is more than the minimum standard deduction amount for dependents ($750 in 2003) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,500 for 2003). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $75 (in 2003), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($750 in 2003).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[436] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[437] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[438]

Taxation of compensation for services under section 1(g)

Compensation for a child's services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g. is the parent's income under local law).[439] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[440]

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[436] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 8 (2002).

[437] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

[438] Sec. 1(g)(7)(B).

[439] Sec. 73(a).

[440] Sec. 6201(c).

Reasons for Change

The "kiddie tax" was enacted to restrict the practice of high-income individuals transferring income-producing property to their children so that the income would be taxed at lower rates. The Committee believes that this rationale for applying the kiddie tax rules to children under 14 also applies to older children who have not yet attained the age of majority.

Explanation of Provision

The provision increases the age of minors to which the kiddie tax provisions apply from under 14 to under 18.

Effective Date

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

II. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue provisions of the "Jumpstart Our Business Strength (JOBS) Act of 2003" as reported.

The bill, as reported, is estimated to have the following budget effects for fiscal years 2003-2013.

[Insert revenue table]

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue provisions of the bill as reported involve new or increased budget authority with respect to section 418 of the bill, relating to the authorization of appropriations for tax law enforcement.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part III. A., above). The revenue increasing provisions of the bill involve reduced tax expenditures (see revenue table in Part II. A., above).

C. Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office submitted the following statement on this bill:

[Insert CBO statement]

CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

November 6,

S. 1637
Jumpstart Our Business Strength (JOBS) Act

As ordered reported by the Senate Committee on Finance on October 2, 2003

SUMMARY

S. 1637 would repeal the exclusion for extraterritorial income, allow a deduction for income attributable to U.S. production activities, and make numerous other changes to existing tax law for corporations. In addition, the bill would extend IRS and customs user fees. The tax provisions of the bill would generally take effect upon enactment of the legislation.

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate the provisions of the bill would decrease federal revenues by about $5.6 billion in 2004. Enacting the bill would increase revenues by about $2.3 billion over the 2004-2008 period, but would decrease revenues by about $16.4 billion over the 2004-2013 period. CBO estimates that the bill would reduce direct spending by $614 million in 2004, about $6.8 billion over the 2004-2008 period, and about $16.7 billion over the 2004-2013 period.

JCT has determined that several tax provisions of S. 1637 contain private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA). CBO has reviewed the non-tax provisions and determined that the extension of the customs user fees is a private-sector mandate as defined in UMRA. In aggregate, the costs of those mandates would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation) in each of the first five years the mandates are in effect. JCT and CBO have determined that S. 1637 contains no intergovernmental mandates as defined in UMRA, and would not affect the budgets of state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of S. 1637 is shown in the following table. The costs of the legislation fall within budget functions 550 (health), 750 (administration of justice), and 800 (general government).

	By Fiscal Year, in Millions of Dollars									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
CHANGES IN REVENUES										
Repeal Exclusion for Extraterritorial Income and Provide Transition Relief	605	1,546	2,411	4,547	5,508	5,727	5,993	6,258	6,518	6,789
IRS Contracting for Tax Collections	0	92	172	174	154	140	140	140	140	140
Extend IRS User Fees	0	25	35	36	38	39	41	42	44	45
Other Provisions Increasing Revenues	2,401	3,228	3,578	3,570	3,648	3,751	4,274	5,003	5,434	5,859
Modify Carryback Rules for Losses	-9,438	1,956	1,599	1,210	749	538	380	274	179	115
Reduce Tax Rate on Dividends from Controlled Foreign Corporations	2,713	146	-2,511	-1,376	-903	-599	-413	-327	-288	-211
Allow a Deduction for Income Attributable to U.S. Production Activities	-378	-1,006	-2,022	-4,328	-5,431	-6,311	-8,241	-9,517	-10,762	-12,171
Other Provisions Reducing Revenues	-1,455	-1,650	-2,276	-2,150	-2,919	-3,782	-5,383	-5,674	-6,171	-6,817
Estimated Revenues	-5,552	4,337	986	1,683	844	-497	-3,209	-3,801	-4,906	-6,251
CHANGES IN DIRECT SPENDING										
Installment Agreements for Tax Payments										
Estimated Budget Authority	1	*	*	0	0	0	0	0	0	0
Estimated Outlays	1	*	*	0	0	0	0	0	0	0
IRS Contracting for Tax Collections										
Estimated Budget Authority	0	23	43	43	39	35	35	35	35	35
Estimated Outlays	0	23	43	43	39	35	35	35	35	35
Extension of Customs User Fees										
Estimated Budget Authority	-619	-1,464	-1,546	-1,632	-1,722	-1,818	-1,919	-2,025	-2,138	-2,257
Estimated Outlays	-619	-1,464	-1,546	-1,632	-1,722	-1,818	-1,919	-2,025	-2,138	-2,257
Taxing Hepatitis A Vaccine										
Estimated Budget Authority	5	7	7	7	7	7	7	7	7	7
Estimated Outlays	5	7	7	7	7	7	7	7	7	7
Total Changes										
Estimated Budget Authority	-614	-1,434	-1,496	-1,582	-1,676	-1,776	-1,877	-1,983	-2,096	-2,215
Estimated Outlays	-614	-1,434	-1,496	-1,582	-1,676	-1,776	-1,877	-1,983	-2,096	-2,215

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	By Fiscal Year, in Millions of Dollars									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
CHANGES IN SPENDING SUBJECT TO APPROPRIATION										
Tax Law Enforcement										
Authorization Level	300	300	300	300	300	300	300	300	300	300
Estimated Outlays	278	297	299	299	299	299	299	299	299	299
Extension of IRS User Fees										
Estimated Authorization Level	0	3	4	4	4	4	4	4	4	5
Estimated Outlays	0	3	4	4	4	4	4	4	4	5
Total Changes										
Estimated Authorization Level	300	303	304	304	304	304	304	304	304	305
Estimated Outlays	278	300	303	303	303	303	303	303	303	304

SOURCES: CBO and the Joint Committee on Taxation.

NOTES: Positive (negative) changes in revenues correspond to decreases (increases) in budget deficits. Positive (negative) changes in direct spending correspond to increases (decreases) in budget deficits.

* = Increase of less than $500,000.

BASIS OF ESTIMATE

Revenues

JCT provided all the revenue estimates, with the exception of the extension of IRS user fees. A little more than half of the provisions contained in S. 1637 that would affect federal revenues would increase receipts over the 2004-2013 period. The remaining provisions would reduce governmental receipts. On net, CBO and JCT estimate the provisions of the bill would decrease federal revenues by about $5.6 billion in 2004. Enacting the bill would increase revenues by about $2.3 billion over the 2004-2008 period and decrease revenues by about $16.4 billion over the 2004-2013 period.

The largest increase in revenues would come from repealing the exclusion for extraterritorial income (ETI). In conjunction with the repeal, the bill also would provide transition relief for certain corporations through January 1, 2007. JCT estimates enacting these provisions would increase federal revenues by $605 million in 2004, about $14.6 billion over the 2004-2008 period, and about $45.9 billion over the 2004-2013 period.
The bill also would allow the IRS to enter into qualified tax collection contracts with private collection agencies (PCAs) to collect delinquent tax liabilities. Such agents would be given specific, limited information regarding a taxpayer's outstanding tax liability. JCT estimates this provision would result in an increase in revenues of $592 million over the 2005-2008 period and about $1.3 billion over the 2005-2013 period.

In addition, S. 1637 would make many other changes to tax law that would raise revenues over the 2004-2013 period. Some of these changes include:

- Clarifying the economic substance doctrine and other related penalty provisions;
- Altering the tax treatment of tax shelters;
- Providing consistent amortization periods for intangibles;
- Repealing the 10 percent rehabilitation credit for non-historic buildings;
- Modifying rules relating to deductions for charitable contributions of patents and other similar property;
- Adding Hepatitis A to the list of taxable vaccines; and
- Allowing the IRS to enter into installment agreements for certain tax payments.

All together, JCT estimates that the additional revenue-raising provisions would increase governmental receipts by about $2.4 billion in 2004, $16.4 billion over the 2004-2008 period, and $40.7 billion over the 2004-2013 period. This total does not include extending IRS user fees, which currently are set to expire on December 31, 2004. The bill would extend the fees through September 30, 2013. CBO estimates this would increase revenues by $135 million over the 2005-2008 period and $345 million over the 2005-2013 period. In addition, the provisions adding Hepatitis A to the list of taxable vaccines, allowing the IRS to contract with private debt collectors, and authorizing the IRS to enter into installment agreements all would affect direct spending (see "Direct Spending" section).

Two provisions would increase receipts in some years but decrease receipts over the 2004-2013 period. JCT estimates that changing tax law relating to the carryback of net operating losses would reduce revenues by about $9.4 billion in 2004, and then increase revenues by about $7 billion over the 2005-2013 period. JCT estimates that temporarily reducing the tax rate for certain dividends from controlled foreign corporations would increase receipts by about $2.9 billion over the 2004-2005 period, and then decrease receipts by about $6.6 billion over the 2006-2013 period.

The largest reduction in revenues would come from allowing firms to deduct a portion of income attributable to certain production activities within the United States. The deduction would be phased in over five years. JCT estimates that this provision would reduce governmental receipts by $378 million in 2004, about $13.2 billion over the 2004-2008 period, and about $60.2 billion over the 2004-2013 period.

JCT estimates that, together, the remaining revenue-reducing provisions contained in S. 1637 would decrease governmental receipts by about $1.5 billion in 2004, $10.4 billion over the 2004-2008 period, and $38.3 billion over the 2004-2013 period. These other provisions include modifying interest expense allocation rules used in computing the foreign tax credit limitation and altering the existing manufacturing deduction to include softwood timber, oil refining, partnerships and sole proprietors, and possessions.

Direct Spending

In total, CBO estimates that the bill would decrease direct spending by $614 million in 2004, about $6.8 billion over the 2004-2008 period, and about $16.7 billion over the 2004-2013 period.

Installment Agreements for Tax Payments. Section 484 would allow the IRS to enter into agreements for the partial payment of tax liabilities. Under current law, taxpayers can elect to pay their full tax liability through installments. The IRS charges a fee of $43 for each installment agreement, which it can retain and spend without further appropriation action. CBO estimates that allowing for the partial payment of tax liabilities would increase direct spending by about $1 million over the 2004-2013 period.

IRS Contracting for Tax Collections. As discussed in the Revenues section, section 487 would allow the IRS to contract with PCAs for the partial payment of tax liabilities. The IRS would be allowed to retain and spend up to 25 percent of the amount collected by the PCAs for the cost of services provided under the contracts. CBO estimates that allowing the IRS to retain and spend 25 percent of the amounts collected would increase direct spending by about $323 million over the 2004-2013 period.

Extension of Customs User Fees. Under current law, customs user fees expire on March 31, 2004. Section 485 of S. 1637 would extend these fees through September 30, 2013. CBO estimates that this would increase offsetting receipts by about $17 billion over the 2004-2013 period.

Taxation of Hepatitis A Vaccine. The Hepatitis A vaccine tax provision (section 491) would require vaccine buyers to pay an excise tax on each dose purchased. Medicaid is a major purchaser of vaccines through the Vaccines for Children program, administered through the Centers for Disease Control and Prevention (CDC). CBO assumes that

Medicaid purchases approximately half of the Hepatitis A vaccines sold annually. Based on estimates provided by JCT, CBO expects that implementing section 491would cost the Medicaid program about $47 million over the 2004-2013 period.

Receipts from the tax would go to the Vaccine Injury Compensation Fund (VICF), which is administered by the Health Resources and Services Administration (HRSA). The fund uses tax revenues to pay compensation to claimants injured by vaccines. Once a vaccine becomes taxable, injuries attributed to its use become compensable through this fund. Based on information provided by HRSA and CDC, we assume there will be few compensable claims related to the Hepatitis A vaccine. CBO estimates the provision would increase outlays from the VICF by $21 million over the 2004-2013 period.

Spending Subject to Appropriation

CBO estimates that implementing H.R. 2896 would cost about $1.5 billion over the 2004-2008 period and $3 billion over the 2004-2013 period, subject to the appropriation of the estimated amounts.

Tax Law Enforcement. Section 418 would authorize the appropriation of $300 million annually for tax law enforcement activities to combat tax avoidance transactions, including tax shelters and offshore accounts. Assuming the appropriation of the specified amounts, CBO estimates that implementing this provision would cost $278 million in 2004 and about $3 billion over the 2004-2013 period.

Extension of IRS User Fees. Section 482 would extend the authority of the IRS to charge taxpayers fees for certain rulings, opinion letters, and determinations through September 30, 2013. The bill would authorize the IRS to retain and spend a portion of the fees collected, subject to appropriation. Based on the historical level of fees spent, CBO estimates that implementing this provision would cost $15 million over the 2005-2008 period and $36 million over the 2005-2013 period, subject to the appropriation of the necessary amounts.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

JCT and CBO have reviewed the provisions of S. 1637 and have determined that the bill contains no intergovernmental mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

JCT has determined that several tax provisions of S. 1637contain private-sector mandates as defined in UMRA. Those are the provisions which:

1. Repeal the exclusion for extraterritorial income,
2. Alter tax law relating to tax shelters,
3. Alter the limitation on transfer or importation of built-in losses,
4. Modify the tax treatment of inversion transactions,
5. Expand the lease term to include certain service contracts,
6. Provide special rules for certain film and television productions,
7. Modify the qualification rules for tax-exempt property and casualty insurance companies,
8. Alter the tax treatment of charitable contributions of patents or similar property,
9. Establish specific class lives for utility grading costs,
10. Repeal the rehabilitation credit in the case of non-historic buildings,
11. Increase the age limit regarding the taxation of certain minors, and
12. Provide consistent amortization periods for intangibles.

In aggregate, the costs of those mandates would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation) in each of the first five years the mandates are in effect.

CBO has reviewed the non-tax provisions of S. 1637 and determined that the extension of the customs user fees is a private-sector mandate as defined in UMRA. S. 1637 would extend through 2013 customs user fees that are scheduled to expire at the end of March 2004 under current law. CBO cannot determine the direct cost of this provision, however, because UMRA does not clearly specify how to calculate the cost associated with extending an existing mandate that has not yet expired. Under one interpretation, UMRA requires the direct cost to be measured relative to a case that assumes that the current mandate will not exist beyond its current expiration date. Under that interpretation, CBO estimates that the direct cost of the mandate would be more than $600 million in 2004 and larger in later years. Under the other interpretation, UMRA requires the direct cost to be measured relative to the mandate currently in effect. Under that interpretation, the direct cost of this provision would be zero.

PREVIOUS CBO ESTIMATE

On November 5, 2003, CBO transmitted a cost estimate for H.R. 2896, the American Jobs Creation Act of 2003, as ordered reported by the House Committee on Ways and Means on October 28, 2003. CBO estimated that enacting H.R. 2896 would decrease federal revenues by about $76.6 billion and direct spending by about $17.1 billion over the 2004-2013 period. By comparison, CBO estimates that enacting S. 1637 would decrease revenues by about $16.4 billion and direct spending by about $16.7 billion over the same period. Both bills would repeal the exclusion for extraterritorial income and provide some transition relief to corporations; however, H.R. 2896 would reduce the tax rate on certain corporate income, while S. 1637 would provide corporations with a deduction for certain U.S. production activity. Many of the other provisions of the bills also differ, and our cost estimates reflect those differences.

ESTIMATE PREPARED BY:

Federal Revenues: Annabelle Bartsch (226-2680)

Federal Spending:
Installment Agreements and Private Debt Collection: Matthew Pickford
Extension of Customs User Fees: Mark Grabowicz
Hepatitis A Vaccine: Tom Bradley

Impact on State, Local, and Tribal Governments: Melissa Merrell

Impact on the Private Sector: Patrice Gordon and Paige Piper/Bach

ESTIMATE APPROVED BY:

G. Thomas Woodward
Assistant Director for Tax Analysis

Peter H. Fontaine
Deputy Assistant Director for Budget Analysis

III. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the standing rules of the Senate, the following statements are made concerning the roll call votes in the Committee's consideration of the "Jumpstart Our Business Strength (JOBS) Act of 2003."

<u>Motion to report the Bill</u>

An original bill, the "Jumpstart our Business Strength Act," was ordered favorably reported, by a roll call vote on October 1, 2003:

> Ayes: Grassley, Hatch, Lott, Snowe, Thomas, Santorum, Frist, Smith, Bunning (proxy), Baucus, Rockefeller, Daschle, Breaux, Conrad, Graham (proxy), Jeffords (proxy), Bingaman, Kerry (proxy), Lincoln
>
> Nays: Nickles, Kyl

<u>Votes on other amendments</u>

The Committee rejected an amendment by Senator Breaux to add certain anti-abuse measures to the provision related to the repatriation of foreign earnings, by roll call vote.

> Ayes: Baucus (proxy), Rockefeller, Daschle (Proxy), Breaux, Conrad (proxy), Graham (proxy), Jeffords (proxy), Bingaman (proxy), Kerry (proxy), Lincoln
>
> Nays: Grassley, Hatch (proxy), Nickles, Lott, Snowe, Kyl, Thomas (proxy), Santorum, Frist (proxy), Smith, Bunning.

The Committee accepted an amendment by Senator Santorum to lower the U.S. withholding tax rate on dividends paid to a corporation created or organized in Puerto Rico from 30 percent to 10 percent.

IV. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as reported.

Impact on individuals and businesses

With respect to individuals and businesses, Title I of the bill repeals the present-law extraterritorial income regime. The repeal of this regime may increase the tax burden on domestic manufacturers. Title I also provides a deduction relating to income attributable to U.S. qualified production activities. This new deduction is available to partnerships, S corporations, and sole proprietorships. The provision may decrease the tax burden for businesses that have qualified production activities, but it will also increase administrative and compliance burdens by requiring businesses to keep detailed records in order to qualify for the provision.

Title II of the bill reforms and simplifies the international tax rules related to the U.S. taxation of foreign source income. These modifications relate principally to the foreign tax credit and certain U.S. anti-deferral regimes, and tend to reduce the burden on taxpayers subject to these rules. Taxpayers that do not have operations overseas generally are not affected by these provisions of the bill.

Title III of the bill contains provisions related to domestic manufacturing and general business operations. These provisions include the exclusion of certain indebtedness for small businesses investment companies, the repeal of the personal holding company tax, an increase in section 179 expensing, the extension of the carryback period for net operating losses, and the modification of certain rules related to the film industry, the timber industry, and cooperatives. These rules, both individually and collectively, will reduce the tax burden on businesses.

Title IV of the bill contains provisions to curtail tax shelters, including provisions arising from the investigative report by the staff of the Joint Committee on Taxation relating to Enron Corporation undertaken at the request of the Committee, corporate governance provisions, and provisions to address expatriation by corporations and individuals. In general, these provisions will have an impact on taxpayers that engage in certain tax avoidance transactions. Taxpayers that have not undertaken or planned to undertake such transactions generally are not affected by these provisions of the bill. Title IV of the bill also contains a variety of provisions that are generally designed to result in a better measurement of income.

Impact on personal privacy and paperwork

The provisions of the bill do not impact personal privacy. Individuals will have to keep additional records in order to demonstrate that they qualify for certain tax benefits provided by the bill.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub.L.No. 104-4).

The Committee has determined that the following provisions of the bill contain Federal private sector mandates within the meaning of Public Law 104-4, the Unfunded Mandates Reform Act of 1995: (1) the provision relating to the repeal of the exclusion for extraterritorial income; (2) the provisions designed to curtail tax shelters; (3) the provision relating to the limitation on transfer or importation of built-in losses; (4) the provision relating to the tax treatment of inversion transactions; (5) the provision to expand the lease term to include certain service contracts; (6) the provision relating to special rules for certain film and television productions; (7) the provision to modify the qualification rules for tax-exempt property and casualty insurance companies; (8) the provision relating to the tax treatment of charitable contributions of patents or similar property; (9) the provision to establish specific class lives for utility grading costs; (10) the provision to repeal the rehabilitation credit in the case of non-historic buildings; (11) the provision relating to the increase in the age limit regarding the taxation of certain minors; and (12) the provision to provide consistent amortization periods for intangibles.

The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provisions include improved administration of the tax laws and a more accurate measurement of income for Federal income tax purposes.

The tax provisions in the reported bill contain no intergovernmental mandates within the meaning of Public Law 104-4, the Unfunded Mandates Reform Act of 1995.

C. Tax Complexity Analysis

The following tax complexity analysis is provided pursuant to section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998, which requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service ("IRS") and the Treasury Department) to provide a complexity analysis of tax legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or a Conference Report containing tax provisions. The complexity analysis is required to report on the complexity and administrative issues raised by provisions that directly or indirectly amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS and the Treasury Department regarding each of the provisions included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

1. Deduction relating to income attributable to United States production activities (sec. 102 of the bill)

Summary description of provision

The bill provides a deduction attributable to the income from certain qualified production activities of a C corporation, S corporation, partnership or sole proprietorship. The term "qualified production activities" generally includes manufacturing, production, growth or extraction of certain tangible personal property, computer software, and property described in section 168(f)(3) or (4) of the Code.

The amount of the deduction in taxable years beginning in 2003, 2004, 2005, 2006, 2007, 2008, and 2009 and thereafter generally is one, one, two, three, six, six, and nine percent, respectively, of the income from qualified production activities. The deduction is limited for a taxable year to 50 percent of the wages paid by the taxpayer during such taxable year. In addition, the deduction cannot exceed the lesser of the taxpayer's taxable income (computed without regard to the deduction) or the taxpayer's qualified production activities income.

For purposes of determining the deduction, income from qualified production activities is reduced by virtue of a fraction, the numerator of which is the value of the domestic production of the taxpayer and the denominator of which is the value of the worldwide production of the taxpayer (the "domestic/worldwide fraction"). For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is reduced by 25, 50, and 75 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

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

Number of affected taxpayers

It is estimated that the provision will affect more than 10 percent of small businesses.

Discussion

It is anticipated that small businesses engaged in qualified production activities will need to keep additional records due to this provision, and that extensive additional regulatory guidance will be necessary to effectively implement the provision. It is anticipated that the provision will result in an increase in disputes between small businesses and the IRS. Reasons for such disputes include the complexity of the provision and the inherent incentive for small businesses and other taxpayers to characterize their activities as qualified production activities to claim the deduction under the provision.

The provision likely will increase the tax preparation costs for most small businesses that are, or may be, engaged in qualified production activities. Small businesses will have to perform additional analysis and make subjective determinations concerning whether their activities constitute qualified production activities and, thus, whether income attributable to such activities qualifies for the deduction allowed under the provision. In this regard, the provision does not provide detailed definitions of the activities that produce income eligible for the deduction, and it will be difficult for the Treasury Secretary to define qualified production activities administratively. It should be noted that a similar provision in the Canadian tax laws was found to be highly complex and difficult to administer, which led to numerous disputes and litigation between affected taxpayers and the Canadian tax authorities. Canada recently repealed the provision and provided a general reduction in corporate tax rates.

For income that is determined to be eligible for the deduction under the provision, small businesses will be required to perform additional and complex calculations to determine the amount of the deduction under the provision. Because the deduction is based upon modified taxable income rather than gross income, small businesses will be required to undertake complicated calculations to determine the amount of costs that are allocable to gross income from qualified production activities. In many cases, small businesses would not have been required otherwise to perform these calculations but for the provision.

The wage limitation on the deduction is likely to impact small businesses disproportionately. After undertaking the calculations and analyses to determine the amount of their potential deduction, many small business will find that such amount is significantly reduced, or eliminated altogether, by the wage limitation.

Under the provision, it may be necessary for small businesses to make certain allocations of income that are not required under present law, particularly with respect to businesses that have both income that is directly attributable to qualified production activities and income that is attributable to processes associated with qualified production activities (e.g., vertically integrated manufacturers that also engage in the selling, storage, and installation of manufactured goods). To the extent the deduction under the provision is not based upon income from processes associated with qualified production activities, taxpayers that engage in such processes will be required to allocate their aggregate income between qualified production activities and processes associated with qualified production activities. In general, it is expected that the multiple calculations and analyses required by this provision will lead to intentional or inadvertent noncompliance among small businesses, as well as other taxpayers.

Due to the detailed calculations required by the provision, it is anticipated that the Secretary of the Treasury will have to make appropriate revisions to several types of income tax forms, schedules, spreadsheets and instructions.

[Insert IRS letter]

ESTIMATED BUDGET EFFECTS OF S. 1637,
THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT,"
AS REPORTED BY THE COMMITTEE ON FINANCE

Fiscal Years 2004 - 2013

[Millions of Dollars]

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
Provisions Relating to Repeal of Exclusion for Extraterritorial Income													
1. Repeal of exclusion for extraterritorial income [1]	toa DOE	3,710	4,780	5,093	5,312	5,508	5,727	5,993	6,258	6,518	6,789	24,403	55,688
2. Deduction relating to income attributable to United States production activities	tyea DOE	-378	-1,006	-2,022	-4,328	-5,431	-6,311	-8,241	-9,517	-10,762	-12,171	-13,165	-60,167
Total of Provisions Relating to Repeal of Exclusion for Extraterritorial Income		**3,332**	**3,774**	**3,071**	**984**	**77**	**-584**	**-2,248**	**-3,259**	**-4,244**	**-5,382**	**11,238**	**-4,479**
General Transition for Repeal of Exclusion for Extraterritorial Income	**toa DOE & before 2007**	**-3,105**	**-3,234**	**-2,682**	**-765**	**---**	**---**	**---**	**---**	**---**	**---**	**-9,786**	**-9,786**
International Tax Provisions													
A. International Tax Reform													
1. 20-year foreign tax credit carryover; 1-year foreign tax credit carryback..	[2]	-165	-214	-271	-338	-500	-686	-858	-995	-1,166	-1,363	-1,488	-6,556
2. Apply look-through rules for dividends from noncontrolled section 902 corporations	tyba 12/31/02	-585	-77	-51	-23	-6	-1	[3]	[3]	[3]	[3]	-742	-743
3. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	---	-236	-355	-338	-334	-333	-334	-338	-344	-352	-1,263	-2,964
4. Recharacterize overall domestic loss	lf tyba 12/31/06	---	---	---	-57	-680	-713	-756	-793	-829	-862	-737	-4,690
5. Interest expense allocation rules	tyba 12/31/08	---	---	---	---	---	-908	-2,487	-2,586	-2,689	-2,797	---	-11,467
6. Determination of foreign personal holding company income with respect to transactions in commodities	teia 12/31/04	---	-4	-10	-10	-10	-10	-11	-11	-11	-11	-34	-88
B. International Tax Simplification													
1. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules	[4]	---	-25	-65	-73	-81	-91	-102	-114	-128	-143	-244	-822
2. Expand the subpart F de minimis rule to the lesser of 5% of gross income or $5 million	[4]	---	-15	-143	-157	-173	-190	-209	-230	-253	-279	-488	-1,649
3. Attribution of stock ownership through partnerships in determining section 902 and 960 credits	tyba DOE	[3]	-1	-3	-3	-3	-3	-3	-3	-3	-3	-10	-25
4. Limit application of uniform capitalization rules in the case of foreign persons	tyba 12/31/04	---	-125	-278	-79	-27	-8	-12	-14	-16	-18	-509	-577

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
5. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations	pma 12/31/04	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26
6. Eliminate 30% tax on certain U.S.-source capital gains of nonresident individuals	tyba 12/31/03	-1	-2	-2	-2	-3	-3	-3	-3	-3	-3	-10	-25
C. Additional International Tax Provisions................................													
1. Subpart F exception for active aircraft and vessel leasing income..	[5]	---	---	---	-46	-187	-237	-289	-333	-382	-440	-233	-1,914
2. Look-through treatment of payments between related CFCs under foreign personal holding company income rules	[4]	---	-72	-203	-219	-239	-245	-272	-292	-314	-337	-733	-2,193
3. Look-through treatment under subpart F for sales of partnership interests	[4]	---	-39	-91	-96	-101	-106	-111	-116	-122	-129	-327	-911
4. Election not to use average exchange rate for foreign tax paid other than in functional currency	tyba 12/31/04	*Negligible Revenue Effect*											
5. Revision of foreign tax credit rules with respect to "base differences"	tyea DOE	-4	-14	-15	-17	-19	-21	-24	-27	-30	-34	-69	-205
6. Modification of exceptions under subpart F for active financing income..	[4]	*Negligible Revenue Effect*											
7. United States property not to include certain assets of controlled foreign corporations...	[4]	---	-3	-20	-21	-22	-23	-24	-25	-27	-29	-66	-194
8. Provide equal treatment for interest paid by foreign partnerships and foreign corporations doing business in the U.S.	tyba 12/31/03	-1	-2	-2	-2	-2	-2	-2	-2	-3	-3	-9	-21
9. Foreign tax credit treatment of deemed payments under section 367(d)	atar 8/5/97	-22	-4	-5	-5	-5	-5	-5	-5	-5	-5	-41	-66
10. Modify FIRPTA rules for REITs	tyba DOE	-3	-5	-7	-10	-12	-14	-15	-17	-19	-21	-38	-124
11. Temporary rate deduction for certain dividends received from controlled foreign corporations	[6]	2,713	146	-2,511	-1,376	-903	-599	-413	-327	-288	-211	-1,931	-3,769
12. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals	wma DOE	-1	-2	-3	-3	-3	-3	-3	-3	-3	-3	-12	-26
13. Reduce withholding tax applicable to dividends paid to Puerto Rico companies to 10%.......................................	Dpa DOE	-2	-5	-7	-8	-9	-10	-10	-11	-12	-13	-31	-87
14. Require Commerce Department report on adverse decisions of the World Trade Organization	DOE	*No Revenue Effect*											
15. Study of impact of international tax law on taxpayers other than large corporations	DOE	*No Revenue Effect*											
16. Consultative role for the Committee on Finance in connection with the review of proposed tax treaties	DOE	*No Revenue Effect*											
Total of International Tax Provisions		**1,929**	**-701**	**-4,045**	**-2,886**	**-3,322**	**-4,214**	**-5,946**	**-6,248**	**-6,650**	**-7,059**	**-9,026**	**-39,142**
Interaction...	**---**	**13**	**14**	**16**	**17**	**19**	**21**	**245**	**620**	**646**	**674**	**79**	**2,285**
Domestic Manufacturing and Business Provisions													
A. General Provisions													
1. Modifications to qualified small issue bonds - increase capital expenditure limit from $10 to $20 million (maximum bond limit remains at $10 million)	bia DOE	-3	-9	-16	-22	-29	-35	-42	-48	-54	-60	-78	-317

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
2. Expensing of investment in broadband equipment (sunset 12/31/04)	eia 12/31/03	-157	-65	27	23	20	18	17	15	13	13	-151	-75
3. Change the definition of "production period" with regard to the natural aging process for distilled liquors for purposes of the capitalization rules under section 263A	ppba DOE	-25	-50	-44	-32	-20	-7	-1	-1	-1	-1	-169	-181
4. Section 355 "active business test" applied to chains of affiliated corporations	generally da DOE	-6	-7	-7	-7	-8	-8	-9	-9	-10	-11	-35	-82
5. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness	[7]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
6. Modified taxation of imported archery products	asbmpoia 12/31/03	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
7. Modify cooperative marketing to include value-added processing involving animals	tyba DOE	-1	-3	-4	-5	-6	-7	-9	-10	-11	-13	-19	-69
8. Extend declaratory judgment relief to farm cooperatives	pfa DOE	*Revenue Effects Included in Line Above*											
9. Repeal personal holding company tax (sunset 12/31/08)	tyba 12/31/03	-87	-164	-171	-174	-178	-81	---	---	---	---	-774	-855
10. Extend phaseout of section 179	tyba 12/31/02	-99	-54	-47	-16	8	2	-2	-5	-8	-10	-208	-231
11. 3-year carryback of net operating losses and waive AMT 90% limitation on the allowance of losses (including losses carried forward into tax years ending in 2003)	tyei 2003	-9,438	1,956	1,599	1,210	749	538	380	274	179	115	-3,924	-2,437
B. Manufacturing Relating to Films													
1. Special rules for certain film and television production (sunset taxable years beginning after 12/31/08)	pca DOE	-112	-264	-348	-326	-231	-7	239	349	306	157	-1,281	-237
2. Modification of application of the income forecast method of accounting	ppisa DOE	-157	-132	-86	-43	-27	-23	-25	-28	-31	-35	-445	-587
C. Manufacturing Relating to Timber													
1. Deduction of the first $10,000 of qualified reforestation costs	epoia DOE	-21	-51	-39	-27	-14	-2	3	9	14	22	-152	-106
2. Election to treat cutting of timber as sale or exchange	DOE	-1	-2	-4	-8	-11	-12	-16	-19	-21	-24	-26	-120
3. Permit capital gain treatment for outright sales of timber by landowner	sota DOE	*Negligible Revenue Effect*											
4. Modified safe-harbor rules for timber REITs	tyba DOE	[8]	[8]	-1	-1	-2	-3	-3	-4	-4	-5	-4	-23
Total of Domestic Manufacturing and Business Provisions		**-10,109**	**1,153**	**857**	**570**	**249**	**371**	**530**	**521**	**370**	**146**	**-7,274**	**-5,338**
Additional Provisions													
A. Provisions Designed to Curtail Tax Shelters													
1. Clarification of the economic substance doctrine and related penalty provisions	teia DOE	1,031	1,242	1,163	1,049	1,086	1,200	1,335	1,517	1,729	1,970	5,571	13,322
2. Provisions relating to reportable transactions and tax shelters	[9]	92	115	119	120	124	131	139	150	164	179	570	1,333
3. Modification to the substantial understatement penalty	tyba DOE	---	4	11	19	23	26	30	34	38	38	57	223
4. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts	DOE	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	1	3

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
5. Actions to enjoin conduct with respect to tax shelters	DOE	*Negligible Revenue Effect*											
6. Understatement of taxpayer's liability by income tax return preparer	dpa DOE	*Negligible Revenue Effect*											
7. Frivolous tax submissions	[11]	3	3	3	3	3	3	3	3	3	3	15	30
8. Regulation of individuals practicing before the Department of Treasury	ata DOE	*No Revenue Effect*											
9. Extend statute of limitations for undisclosed listed transactions	[12]	---	---	1	1	1	1	1	1	1	1	3	8
10. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions	tyba DOE	---	---	1	1	3	4	4	4	4	4	5	25
11. Authorize additional $300 million per year to the IRS to combat abusive tax avoidance transactions [13]	DOE	*No Revenue Effect*											
B. Other Corporate Governance Provisions													
1. Affirmation of consolidated return regulation authority	[14]	*Negligible Revenue Effect*											
2. Chief executive officer required to sign declaration as part of corporate income tax return	rfa DOE	*Negligible Revenue Effect*											
3. Denial of deduction for certain fines, penalties, and other amounts	generally apoia 4/27/03	101	10	10	10	10	10	10	10	10	10	141	191
4. Denial of deduction for punitive damages	dpoia DOE	38	29	30	31	32	33	34	35	36	37	160	333
5. Criminal tax fraud package	uaoataoa DOE	---	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	5
C. Enron-Related Tax Shelter Provisions													
1. Limitation on transfer or importation of built-in losses	ta 2/13/03	128	123	136	149	164	180	198	218	240	264	700	1,800
2. No reduction of basis under section 734 in stock held by partnership in corporate partner	da 2/13/03	9	13	20	28	36	44	51	54	56	57	105	368
3. Repeal of special rules for FASITs	on 2/13/03	*Negligible Revenue Effect*											
4. Expanded disallowance of deduction for interest on convertible debt	diia 2/13/03	6	88	90	94	96	98	101	103	106	109	374	891
5. Expanded authority to disallow tax benefits under section 269	aa 2/13/03	10	9	9	10	10	11	11	12	12	13	48	108
6. Modification of CFC-PFIC coordination rules	[15]	23	15	8	4	5	6	8	10	12	15	55	106
D. Provisions to Discourage Expatriation													
1. Tax treatment of inversion transactions	[16]	172	137	140	168	202	242	290	348	418	493	819	2,610
2. Impose mark-to-market on individuals who expatriate	[17]	101	84	80	74	71	67	61	57	54	51	410	700
3. Excise tax on stock compensation of insiders in inverted corporations	generally 7/11/02	8	6	6	6	6	7	7	7	7	7	32	68
4. Reinsurance agreements	rra 4/11/02	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	2	5
5. Reporting of taxable mergers and acquisitions	aa DOE	1	2	3	3	3	3	3	3	3	3	12	27
E. International Tax													
1. Clarification of banking business for determining investment of earnings in U.S. property	DOE	---	9	17	17	18	19	20	21	22	23	61	166
2. Prohibition on nonrecognition of gain through complete liquidation of holding company	doo/a DOE	[10]	13	15	17	19	21	23	25	27	29	64	189
3. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons	pao/a DOE	12	41	84	79	33	35	37	39	41	43	249	444

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
4. Effectively connected income to include economic equivalents of certain categories of foreign-source income	tyba DOE	3	5	7	8	9	10	10	10	10	11	32	83
5. Recapture of overall foreign losses on sale of controlled foreign corporation stock	DA DOE	[10]	3	7	8	9	9	9	10	10	10	27	75
6. Minimum holding period for foreign tax credit on withholding tax on income other than dividends	apoamt30da DOE	[10]	3	3	3	3	4	4	4	4	5	12	33
F. Other Revenue Provisions													
1. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds	padoa DOE	2	13	11	8	5	3	[10]	[10]	[10]	[10]	39	42
2. Apply earnings-stripping rules to partnerships and S corporations	tybo/a DOE	3	18	21	22	25	27	29	31	33	35	89	244
3. Recognize cancellation of indebtedness income realized on satisfaction of debt with partnership interest [18]	coio/a DOE	3	4	4	4	4	5	5	5	5	6	19	45
4. Modification of the straddle rules	peo/a DOE	5	17	19	21	24	26	28	29	30	31	86	230
5. Deny installment sale treatment for all readily tradable debt	soo/a DOE	13	51	57	8	11	12	13	15	17	18	140	215
6. Modify treatment of transfers to creditors in divisive reorganizations	to/a DOE	[10]	8	9	10	10	10	11	11	12	12	37	93
7. Clarify definition of nonqualified preferred stock	ta 5/14/03	[10]	5	8	8	8	8	8	8	7	7	29	67
8. Definition of controlled group of corporations	tyba DOE	3	6	5	4	3	2	2	2	1	1	21	29
9. Mandatory basis adjustment of partnership property in the case of partnership distributions and transfers of partnership interests except for transfers by reason of death	tada DOE	15	40	59	73	83	88	91	93	96	99	270	737
10. Extend present-law intangibles amortization provisions to acquisitions of sports franchises	aoa DOE	13	61	94	68	36	23	21	19	22	24	272	381
11. Lease term to include certain service contracts	laosaeia DOE	14	26	41	57	74	92	110	129	150	171	212	864
12. Establish specific class lives for utility grading costs	ppisa DOE	3	14	34	56	73	86	96	107	114	117	182	701
13. Expansion of limitation on depreciation of certain passenger automobiles	ppisa DOE	43	75	76	38	-46	-102	-57	-25	-3	---	187	---
14. Provide consistent amortization periods for intangibles	[19]	-112	214	442	518	552	443	398	342	282	212	1,614	3,291
15. Limitation of tax benefits for leases to certain tax exempt entities	laosaeia DOE	8	16	25	34	44	55	66	78	90	103	127	519
16. Clarification of rules for payment of estimated tax for certain deemed asset sales	toa DOE	51	37	10	3	3	3	3	4	4	5	104	123
17. Extension of IRS user fees (through 9/30/13) [13]	rma DOE	---	25	35	36	38	39	41	42	44	45	93	345
18. Double certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements	oyo/a DOE	2	1	1	[20]	[20]	[20]	[20]	[20]	[20]	[20]	4	6
19. Authorize IRS to enter into installment agreements that provide for partial payment	iaeio/a DOE	48	14	5	[20]	[20]	[20]	[20]	[20]	[20]	[20]	67	67
20. Extension of Customs User Fees													
a. Extend passenger and conveyance processing fee through 9/30/13 [13]	DOE	75	314	329	346	363	381	400	420	441	464	1,427	3,534
b. Extend merchandise processing fee through 9/30/13 [13]	DOE	544	1,151	1,216	1,286	1,359	1,436	1,518	1,605	1,696	1,793	5,556	13,605

Provision	Effective	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
21. Deposits to stop the running of interest on potential underpayments	dma DOE	157	-5	-6	-6	-6	-6	-7	-7	-7	-7	134	101
22. Private debt collection (net of outlays) [21]	DOE	---	70	129	131	116	106	106	106	106	106	445	973
23. Add vaccines against Hepatitis A to the list of taxable vaccines [22]	[23]	6	9	9	9	9	9	9	9	9	9	42	87
24. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence	sopra DOE	[10]	11	13	15	17	19	21	23	25	27	56	171
25. Modify qualification rules for tax-exempt property and casualty insurance companies and definition of insurance company..	tyba 12/31/03	49	107	120	126	131	137	142	148	154	160	534	1,273
26. Provide that deductions for charitable contributions of patents or similar property may not exceed the donor's basis; provide that donor may receive a right to certain payments by the donee	cma 10/1/03	236	356	366	377	389	400	412	425	438	451	1,725	3,851
27. Repeal the 10% rehabilitation credit for non-historic buildings	eii tyba 12/31/03	54	74	79	89	97	106	116	123	134	144	390	1,013
28. Increase age limit under section 1(g)...................................	tyba 12/31/03	34	88	97	109	117	120	123	139	168	185	445	1,180
Total of Additional Provisions ……………………………………………………………….		**3,007**	**4,774**	**5,271**	**5,352**	**5,505**	**5,692**	**6,094**	**6,556**	**7,075**	**7,593**	**23,871**	**56,933**
NET TOTAL ………………………………………………………………………………………….		**-4,933**	**5,780**	**2,488**	**3,272**	**2,528**	**1,286**	**-1,325**	**-1,810**	**-2,803**	**-4,028**	**9,102**	**473**

Joint Committee on Taxation

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

Legend for "Effective" column:

aa = acquisitions after
aoa = acquisitions occurring after
apoamt30da = amounts paid or accrued more than 30 days after
apoia = amounts paid or incurred after
asbmpoia = articles sold by the manufacturer, producer, or importer after
ata = actions taken after
atar = amounts treated as received
bia = bonds issued after
cma = contributions made after
coio/a = cancellations of indebtedness on or after
da = distributions after
DA = dispositions after
diia = debt instrument issued after
dma = deposits made after
DOE = date of enactment
doo/a = distributions occurring on or after
dpa = documents prepared after
Dpa = dividends paid after
dpoia = damages paid or incurred after
eia = expenses incurred after
eii = expenses incurred in
epoia = expenditures paid or incurred after
iaeio/a = installment agreements entered into on or after
laosaeia = leases and other similar arrangements entered into after
lf = losses for
oyo/a = open years on or after
padoa = purchases and dispositions occurring after
pao/a = payments accrued on or after
pca = productions commencing after
peo/a = positions established on or after
pfa = pleadings filed after
pma = payments made after
ppba = production periods beginning after
ppisa = property placed in service after
rfa = returns filed after
rma = requests made after
rra = risk reinsured after
sota = sales of timber after
soo/a = sales occurring on or after
sopra = sales of principal residences after
tada = transfers and distributions after
ta = transactions after
teia = transactions entered into after
toa = transactions occurring after
to/a = transactions on or after
tyba = taxable years beginning after
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
tyei = taxable years ending in
uaoataoa = underpayments and overpayments attributable to actions occurring after
wma = wagers made after

[Footnotes for the Table appear on the following page]

Footnotes for the Table:

[1] Includes estimate for binding contract relief.
[2] Effective for excess foreign taxes that may be carried forward to any taxable year ending after the date of enactment. Carryback period effective for credits arising in taxable years beginning after the date of enactment.
[3] Loss of less than $1 million.
[4] Effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[5] Effective for taxable years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[6] Effective for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment.
[7] Effective for debt incurred by a small business investment company after December 31, 2003, with respect to property acquired after such date.
[8] Loss of less than $500,000.
[9] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the material advisor and investor list disclosure provisions applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the failure to register tax shelter penalty applies to returns the due date for which is after the date of enactment; the investor list penalty applies to requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.
[10] Gain of less than $1 million.
[11] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[12] Effective for taxable years with respect to which the period for assessing deficiencies did not expire before October 1, 2003.
[13] Estimate is subject to review by the Congressional Budget Office.
[14] Effective for all taxable years, whether beginning before, on, or after the date of enactment.
[15] Effective for taxable years of foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[16] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002.
[17] Generally effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after February 5, 2003.
[18] Estimate is preliminary and subject to change pursuant to the receipt of additional information.
[19] Generally effective for start-up and organizational expenditures incurred after the date of enactment.
[20] Gain of less than $500,000.
[21] Breakout of Outlay effects Net of Offsetting Receipts:

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-08	2004-13
Private sector debt collection ……………………………………………………………	---	-22	-43	-43	-38	-34	-34	-34	-34	-34	-148	-323

[22] Estimate contains outlay effects that will be provided by the Congressional Budget Office.
[23] Effective for vaccines sold and used beginning on the first day of the first month beginning more than four weeks after the date of enactment.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Mr. George K. Yin
Chief of Staff
Joint Committee on Taxation
Washington, D.C. 20515

Dear Mr. Yin:

Enclosed are the combined comments of the Internal Revenue Service and the Treasury Department on the new deduction for U.S. production activities in the Senate Finance Committee markup of S. 1637, the "Jumpstart Our Business Strength Act," that you identified for complexity analysis in your letter of October 8, 2003. Our comments are based solely on the description of that provision provided in your letter.

Due to the short turnaround time, our comments are provisional and subject to change upon a more complete and in-depth analysis of the provision.

Sincerely,

Mark W. Everson

Enclosure

COMPLEXITY ANALYSIS OF PROVISION FROM S. 1367,
THE JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT

Deduction Relating to Income Attributable to U.S. Production Activities

Provision:

The provision provides a deduction attributable to income from certain production activities. The amount of the deduction in taxable years beginning in 2004, 2005, 2006, 2007 and 2008, and 2009 and thereafter is one, two, three, six, and nine percent of the income for these activities, respectively. The deduction for any taxable year is limited to 50 percent of the wages paid by the taxpayer during such taxable year.

For purposes of determining the deduction, qualified production activities income is reduced by virtue of a fraction, the numerator of which is the value of the domestic production of the taxpayer and the denominator of which is the value of the worldwide production of the taxpayer (the "domestic/worldwide fraction"). For taxable years beginning before 2010, the reduction in qualified production activities income by virtue of the domestic/worldwide fraction is 100 percent. For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is 75, 50, and 25 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

The provision is effective for taxable years ending after the date of enactment. (Because the above description provides no deduction percentage for taxable years beginning before 2004, our comments are based on the assumption that the percentage is zero for 2003 and the provision could not be effective before 2004.)

IRS and Treasury Comments:

<u>Administration, Compliance and Controversy</u>

- The new deduction for domestic production activities will require the promulgation of extensive, detailed new guidance, particularly in the form of regulations. We anticipate that guidance will be required to address:
  - o which activities constitute production activities;
  - o the statutory exceptions to the definition of production activity;
  - o the allocation of revenues between production and non-production activities;
  - o the allocation of deductions between production and non-production activities;
  - o the application of the limitation based on worldwide production activities including the allocation of revenues and expenses between domestic and worldwide production activities;
  - o the application of the provisions when related and unrelated taxpayers perform parts of the production activity; and
  - o numerous other issues.

- We expect that such guidance will be difficult to craft. By distinguishing "production" from other activities, the provision places considerable tension on defining terms and designing anti-abuse rules.

- Many businesses, particularly small businesses, will find it difficult to understand and comply with these complex new rules, which will affect not only the computation of a taxpayer's regular tax liability but also its alternative minimum tax liability. It will be difficult, if not impossible, for the IRS to craft simplified provisions tailored to small business or other taxpayers.

- Taxpayers will be required to devote substantial additional resources to meeting their tax responsibilities, including not only employees and outside tax advisers, but also recordkeeping and systems modification resources. The resulting costs will reduce significantly the benefits of the proposal. Some small businesses may find that the additional costs outweigh the benefits, particularly during the initial phase-in period.

- It will be necessary to devote significant audit resources to administering the new deduction. This will be due not only to the novelty of the rule but also to the benefits that are provided to "production activities" over other aspects of a taxpayer's business. Taxpayers naturally will classify everything possible as production activities. Audits, particularly those involving integrated businesses, will have to focus on classification and the allocation of income and costs. Significant additional IRS resources will be needed to administer the provision to avoid diverting resources from other compliance issues (such as tax shelters).

- Finally, for all of the reasons discussed above, we anticipate a significant increase in controversies between taxpayers and the IRS. This will increase the number of IRS appeals cases and litigated tax cases.

Tax Forms and Publications

- In addition to the substantive issues noted above, compliance with the provision will require new forms and instructions to be developed by the IRS and used by taxpayers.

- The computation of the deduction relating to income attributable to United States Production Activities would most likely be figured on a new form of at least 10 lines. The instructions for the new form would likely be at least 3 pages.

- Two additional lines would have to be added to each 2004 form or schedule on which the deduction figured on the new form could be claimed. The deduction would be claimed on the following forms and schedules, among others.
  1. Schedule C (Form 1040) (sole proprietors).
  2. Schedule F (Form 1040) (farm businesses).
  3. Schedule E (Form 1040) (rental businesses).

4. Form 1041 (estates and trusts).
5. Form 1065 (partnerships).
6. Form 1065-B (electing large partnerships).
7. Form 1120 (corporations).
8. Form 1120-A (short tax return for corporations).
9. Form 1120-L (life insurance companies).
10. Form 1120-PC (property and casualty insurance companies).
11. Other Form 1120 series returns.
12. Form 1120S (S corporations).

- The instructions for all affected forms and schedules listed above would have to be revised to reflect the new deduction, adding one-half to one full page of instructions to each form and schedule listed above.

- The tax forms and publications for years after 2004 would have to be updated to reflect the increasing percentage of qualified activities production income and the decreasing percentage of domestic/worldwide fraction taken into account until the provision is fully phased in 2013.

- Programming changes will be required to reflect the new 10 line form, the two additional lines on the above forms and schedules, and the changing percentages. Currently, the IRS tax computation programs are updated annually to incorporate mandated inflation adjustments. Any programming changes necessitated by the provision would be included during that process.

- The following 2004 publications, among others, would have to be revised to cover the new deduction, adding 3 to 6 pages to each.
  1. Publication 541 (corporations).
  2. Publication 542 (partnerships).
  3. Publication 535 (business expenses—primarily individuals).
  4. Publication 225 (farmers).
  5. Publication 334 (small business tax guide).

- Training materials and Internal Revenue Manuals will have to be revised to reflect the new deduction.

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V. ADDITIONAL VIEWS

ADDITIONAL VIEWS OF SENATOR SMITH

I write as a strong supporter of S. 1637 -- a balanced and bipartisan effort championed by Chairman Chuck Grassley. I do believe that his efforts on this bill will help most domestic manufacturers in the United States. I will continue to support the bill with the following reservation:

The centerpiece of the JOBS Act is a benefit for manufacturers that has the effect of reducing the rate on manufacturing income over time by 3 percentage points.

This rate cut, however, is not applied equally to all U.S. manufacturers. This bill includes a provision – a "haircut" – that provides less of a benefit to companies that ALSO manufacture abroad. For example, a company that has 55% of its manufacturing in the U.S. and 45% abroad will calculate its benefit under the bill and then reduce that benefit by a fraction -- the numerator of which is the gross receipts from domestic manufacturing over the same derived from worldwide manufacturing.

This company suffers twice. First, the manufacturing benefit in S. 1637 is less than the benefit currently provided under FSC/ETI. Secondly, this company's manufacturing benefit is further reduced by the "haircut" merely because it also has overseas manufacturing operations.

While the Finance Committee passed the bill with this "haircut"" to save revenue, I and many of my colleagues would like to find a way to completely eliminate it for the following reasons:

- The "haircut" treats U.S. jobs created by multinational companies as "less worthy" than U.S. jobs created by strictly domestic manufacturers. Congress should be in the business of rewarding all well-paid, manufacturing jobs that are created in the U.S. – not just those created by strictly domestic manufacturers.

- The "haircut" makes the U.S. a less competitive location for current and future investment because multinational companies will believe they are being "cheated" and discriminated against.

- The "haircut" is inconsistent with historic tax and trade policies to encourage U.S. companies to open up facilities outside the U.S. In fact, there is an entire Department – the Department of Commerce – set up to assist U.S. companies going global and then to promote and facilitate those same companies' efforts once they have established themselves in-country.

- The "haircut" invites mirror legislation in other countries.

- The "haircut" could invite another WTO challenge to this legislation.

Minority Views of Senator Don Nickles and Senator Jon Kyl

We respectfully file our dissenting views to the Jumpstart Our Business Strength (JOBS) Act, which was approved by the Senate Finance Committee on October 1, 2003. We appreciate the hard work of the chairman and the committee staff on this legislation to bring our tax laws into compliance with our World Trade Organization obligations and to address economic concerns of U.S. domestic manufacturers. Unfortunately, the committee-approved legislation deviates so greatly from sound tax policy that we voted against it and feel compelled to explain why.

Our primary concern with the JOBS Act is the deduction it provides for manufacturing income. The chairman explained that the deduction is designed to effect a reduction in the corporate tax rate applied to manufacturing income. The tax cut was structured as a deduction for financial reporting purposes, but the end result is that it provides a lower tax rate for manufacturers than for other U.S. businesses. This is bad tax policy and is virtually without precedent in our history. While Congress has built into the tax code numerous preferences in the form of credits or deductions for favored activities, it has never before (to our knowledge) explicitly sought to provide a lower tax rate for one type of corporation over others.

There is broad agreement among tax authorities that taxes should be neutral, fair and efficient. When the Finance Committee considered the JOBS Act, we offered an amendment to replace the manufacturing deduction and the miscellaneous international reforms with a reduction in the top corporate rate from the current 35 percent to 33 percent. Our proposal meets all of these tax policy goals, while the manufacturing deduction does not.

A reduction in the top corporate tax rate for all corporations is neutral in that it will not influence a company's resource allocation or encourage unproductive, tax-induced activity. It is fair in that it retains an equitable distribution of the tax burden; it does not favor one type of business over others. It is efficient in that it will not be costly for the government to administer or taxpayers to calculate and will not encourage gaming of the system by providing new loopholes.

In contrast, the manufacturing deduction in the JOBS Act meets none of these standards.

The manufacturing deduction is not neutral because it could cause companies with a variety of business operations to shift more resources to their manufacturing operations to take advantage of the lower rates, even if that is not the most productive use of their resources. We believe that the reported bill will lead us down the slippery slope of industries pressuring Congress to expand the definition of "manufacturing" in the future to allow them to qualify for the deduction, regardless of whether the industry can properly be defined as a manufacturing industry. We see this already in the reported bill, which allows films to qualify for the manufacturing deduction. We know that special-interest tax provisions for favored industries lead to unproductive, tax-driven economic activity; we should not add yet another such provision to our tax code.

It is unfair in that the deduction is available only to U.S. manufacturers; it penalizes all other U.S. businesses, subjecting them to a 35 percent rate while manufacturers enjoy a 32 percent rate.

It is inefficient in that companies will have to segregate their manufacturing income to take advantage of the relief. When asked, the Treasury Department suggested that the manufacturing deduction would be virtually unadministrable.

Congress must recognize that our corporate income tax rate is too high for all U.S. companies, not just for manufacturers. Currently, the U.S. has the second highest corporate tax rate among the countries of the Organization for Economic Cooperation and Development. Only Japan has a higher rate. This puts all U.S. companies, not just manufacturers, at a competitive disadvantage. Our proposal to reduce the top corporate rate to 33 percent will begin to address this problem.

Many will argue that we must do something to help U.S. manufacturers in particular. We believe that we must do something to help all U.S. companies. Our efforts to carve-out special tax breaks for manufacturers have not had a successful track-record. In the three decades that we have tried to provide tax incentives for U.S. exports, study after study has shown that the special tax provisions have done little to retain U.S. jobs. The time has come to try something new and to recognize that sound tax policy will be better for our country's economic growth than will more targeted tax breaks.

We urge all members of the Senate to consider very carefully whether it is sensible tax policy to create a special tax rate for manufacturing income while continuing to tax other types of corporate income at the higher 35 percent rate.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).