DESCRIPTION OF THE CHAIRMAN'S MARK FOR THE CONFERENCE COMMITTEE ON H.R. 4520

October 4, 2004

Contents

Page

TITLE I - PROVISIONS RELATING TO REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME 1

A. Repeal of Exclusion for Extraterritorial Income 1
B. Deduction Relating to Income Attributable to United States Production Activities 3

TITLE II – BUSINESS TAX INCENTIVES 7

A. Small Business Expensing 7
1. Section 179 expensing 7
B. Depreciation 9
1. Recovery period for depreciation of certain leasehold improvements 9
2. Recovery period for depreciation of certain restaurant improvements 11
C. Community Revitalization 13
1. Modification of targeted areas and low-income communities designated for new markets tax credit 13
2. Expansion of designated renewal community area based on 2000 census data 15
3. Modification of income requirement for census tracts within high migration rural counties for new markets tax credit 16
D. S Corporation Reform and Simplification 18
1. Shareholders of an S corporation 18
2. Treatment of S corporation shareholders 20
3. Exclusion of investment securities income from passive income test for bank S corporations 22
4. Qualified subchapter S subsidiaries 22
5. Repayment of loan for qualifying employer securities held by an ESOP 23
E. Other Business Incentives 26
1. Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels 26
2. Modification of application of income forecast method of depreciation 26
3. Improvements related to real estate investment trusts 28
4. .Special rules for certain film and television production 37
5. Provide a tax credit for maintenance of railroad track 38
6. Suspension of occupational taxes relating to distilled spirits, wine, and beer 39
7. Modification of unrelated business income limitation on investment in certain small business investment companies 41
8. Election to determine taxable income from certain international shipping activities using per ton rate 42
F. Stock Options and Employee Stock Purchase Plan Stock Options 46
1. Exclusion of incentive stock options and employee stock purchase plan stock options from wages 46

Page

TITLE III – AGRICULTURAL TAX RELIEF AND INCENTIVES 48

A. Volumetric Ethanol Excise Tax Credit 48
1. Incentives for alcohol and biodiesel fuel mixtures 48
2. Biodiesel income tax credit 55
3. Information reporting for persons claiming certain tax benefits 56
B. Agriculture Incentives 58
1. Special rules for livestock sold on account of weather-related conditions 58
2. Payment of dividends on stock of cooperatives without reducing patronage dividends 59
3. Modifications to small producer ethanol credit 60
4. Extend income averaging to farmers; coordinate farmers and fishermen income averaging and the alternative minimum tax 61
5. Capital gain treatment to apply to outright sales of timber by landowner 62
6. Modification to cooperative marketing rules to include value added processing involving animals 62
7. Extension of declaratory judgment procedures to farmers' cooperative organizations 63
8. Modified safe harbor rules for timber REITs 64
9. Expensing of reforestation expenditures 69
C. Other Incentives 70
1. Net income from publicly traded partnerships treated as qualifying income of regulated investment company 70
2. Simplification of excise tax imposed on bows and arrows 71
3. Reduce rate of excise tax on fishing tackle boxes to three percent 73
4. Repeal of excise tax on sonar devices suitable for finding fish 73
5. Charitable contribution deduction for certain expenses in support of Native Alaskan subsistence whaling 74
6. Extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry) 75
7. Special placed in service rule for bonus depreciation for certain property subject to syndication 78
8. Expensing of capital costs incurred for production in complying with environmental protection agency sulfur regulations for small refiners 79
9. Credit for small refiners for production of diesel fuel in compliance with environmental protection agency sulfur regulations for small refiners 80

TITLE IV – TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES 82

A. Interest Expense Allocation Rules 82
B. Recharacterize Overall Domestic Loss 87
C. Apply Look-Through Rules for Dividends from Noncontrolled Section 902 Corporations 90
D. Foreign Tax Credit Baskets and "Base Differences" 92
E. Attribution of Stock Ownership Through Partnerships In Determining Section 902 and 960 Credits 96

Page

F. Foreign Tax Credit Treatment of Deemed Payments Under Section 367(d) of the Code 98
G. United States Property Not to Include Certain Assets of Controlled Foreign Corporations 100
H. Translation of Foreign Taxes 103
I. Eliminate Secondary Withholding Tax with Respect to Dividends Paid by Certain Foreign Corporations 105
J. Provide Equal Treatment for Interest Paid by Foreign Partnerships and Foreign Corporations 107
K. Treatment of Certain Dividends of Regulated Investment Companies 108
L. Look-through Treatment Under Subpart F for Sales of Partnership Interests 114
M. Repeal of Foreign Personal Holding Company Rules and Foreign Investment Company Rules 115
N. Determination of Foreign Personal Holding Company Income with Respect to Transactions in Commodities 116
O. Modifications to Treatment of Aircraft Leasing and Shipping Income 119
P. Modification of Exceptions Under Subpart F for Active Financing 122
Q. Ten-Year Foreign Tax Credit Carryover; One-Year Foreign Tax Credit Carryback 124
R. Modify FIRPTA Rules for Real Estate Investment Trusts 126
S. Exclusion of Certain Horse-Racing and Dog-Racing Gambling Winnings from the Income of Nonresident Alien Individuals 128
T. Limitation of Withholding on U.S.-Source Dividends Paid to Puerto Rico Corporation 130
U. Foreign Tax Credit Under Alternative Minimum Tax 132
V. Incentives to Reinvest Foreign Earnings in the United States 133
W. Delay in Effective Date of Final Regulations Governing Exclusion of Income from International Operations of Ships and Aircraft 136
X. Study of Earnings Stripping Provisions 137

TITLE V – DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES 138

TITLE VI – FAIR AND EQUITABLE TOBACCO REFORM 140

TITLE VII – MISCELLANEOUS PROVISIONS 142

A. Brownfields Demonstration Program for Qualified Green Building and Sustainable Design Projects 142
B. Exclusion of Gain or Loss on Sale or Exchange of Certain Brownfield Sites from Unrelated Business Taxable Income 146
C. Civil Rights Tax Relief 154
D. Seven-Year Recovery Period for Certain Track Facilities 156
E. Distributions to Shareholders from Policyholders Surplus Account of Life Insurance Companies 157
F. Treat Certain Alaska Pipeline Property as Seven-Year Property 159
G. Enhanced Oil Recovery Credit for Certain Gas Processing Facilities 160
H. Method of Accounting for Naval Shipbuilders 161

Page

I. Minimum Cost Requirement for Excess Defined Benefit Pension Plan Asset Transfers 162
J. Blue Ribbon Commission on Comprehensive Tax Reform 165
K. Credit for Electricity Produced From Certain Sources 166
L. Certain Business Energy Credits Allowed Against the Alternative Minimum Tax 169
M. Inclusion of Primary and Secondary Medical Strategies for Children and Adults With Sickle Cell Disease as Medical Assistance under the Medicaid Program 171
N. Suspension of Duties on Ceiling Fans 174
O. Suspension of Duties on Nuclear Steam Generators 175
P. Suspension of Duties on Nuclear Reactor Vessel Heads 176

TITLE VIII – REVENUE PROVISIONS 177

A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation 177
1. Tax treatment of expatriated entities and their foreign parents 177
2. Excise tax on stock compensation of insiders in expatriated corporations 181
3. Reinsurance of U.S. risks in foreign jurisdictions 185
4. Revision of tax rules on expatriation of individuals 186
5. Reporting of taxable mergers and acquisitions 191
6. Studies 193
B. Taxpayer Shelter Proposals 195
1. Penalty for failing to disclose reportable transactions 195
2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose 198
3. Tax shelter exception to confidentiality privileges relating to taxpayer communications 202
4. Statute of limitations for unreported listed transactions 203
5. Disclosure of reportable transactions by material advisors 204
6. Investor lists and modification of penalty for failure to maintain investor lists 207
7. Penalties on promoters of tax shelters 209
8. Modifications to the definition of the substantial understatement 210
9. Actions to enjoin conduct with respect to tax shelters and reportable transactions 211
10. Penalty for failure to report interests in foreign financial accounts 212
11. Regulation of individuals practicing before the Department of the Treasury 213
12. Treatment of stripped interests in bond and preferred stock funds, etc. 214
13. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends 217
14. Treatment of partnership loss transfers and partnership basis adjustments 219
15. No reduction of basis under section 734 in stock held by partnership in corporate partner 223
16. Repeal of special rules for FASITs, etc. 225
17. Limitation on transfer and importation of built-in losses 230
18. Clarification of banking business for purposes of determining investment of earnings in U.S. property 231

19. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions 233
20. Clarification of rules for payment of estimated tax for certain deemed asset sales 234
21. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence 235
22. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons 236
23. Deposits made to suspend the running of interest on potential underpayments 238
24. Authorize IRS to enter into installment agreements that provide for partial payment 241
25. Affirmation of consolidated return regulation authority 241
26. Expanded disallowance of deduction for interest on convertible debt 246
27. Reform of tax treatment of certain leasing arrangements and limitation on deductions allocable to property used by governments or other tax-exempt entities 248
C. Reduction of Fuel Tax Evasion 256
1. Exemption from certain excise taxes for mobile machinery vehicles 256
2. Modify definition of off-highway vehicle 257
3. Taxation of Aviation-Grade Kerosene 260
4. Mechanical dye injection and penalties related to dyeing of fuel 266
5. Terminate dyed diesel use by intercity buses 268
6. Authority to inspect on-site records 269
7. Assessable penalty for refusal of entry 270
8. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries 271
9. Display of registration and penalties for failure to display registration and to register 272
10. Registration of persons within foreign trade zones 273
11. Penalties for failure to report 274
12. Electronic information reporting 274
13. Taxable fuel refunds for certain ultimate vendors 275
14. Two-party exchanges 276
15. Modification of the use tax on heavy highway vehicles 277
16. Dedication of revenues from certain penalties to the Highway Trust Fund 278
17. Simplification of tax on tires 279
18. Transmix and diesel fuel blendstocks treated as taxable fuel 280
19. Treasury study on taxable fuel compliance 282
D. Other Revenue Provisions 284
1. Permit private sector debt collection companies to collect tax debts 284
2. Modify charitable contribution rules for donations of patents and other intellectual property 284
3. Require increased reporting for noncash charitable contributions 288
4. Limit deduction for charitable contributions of vehicles 290
5. Treatment of nonqualified deferred compensation plans 292

6. Extend the present-law intangible amortization provisions to acquisitions of sports franchises 302
7. Increase continuous levy for certain federal payments 303
8. Modification of straddle rules 304
9. Add vaccines against Hepatitis A to the list of taxable vaccines 308
10. Add vaccines against influenza to the list of taxable vaccines 309
11. Extension of IRS user fees 310
12. Extension of customs user fees 310
13. Prohibition on nonrecognition of gain through complete liquidation of holding company 311
14. Effectively connected income to include certain foreign source income 312
15. Recapture of overall foreign losses on sale of controlled foreign corporation stock 315
16. Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest 317
17. Denial of installment sale treatment for all readily tradable debt 319
18. Modify treatment of transfers to creditors in divisive reorganizations 319
19. Clarify definition of nonqualified preferred stock 320
20. Modify definition of controlled group of corporations 321
21. Establish specific class lives for utility grading costs 323
22. Provide consistent amortization period for intangibles 324
23. Freeze of provision regarding suspension of interest where Secretary fails to contact taxpayer 325
24. Increase in withholding from supplemental wage payments in excess of $1 million 326
25. Capital gain treatment on sale of stock acquired from exercise of statutory stock options to comply with conflict of interest requirements 327
26. Application of basis rules to nonresident aliens 328
27. Deduction for personal use of company aircraft and other entertainment expenses 332
28. Residence and source rules relating to United States possessions 334
29. Dispositions of transmission property to implement Federal Energy Regulatory Commission restructuring policy 337

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

A. Repeal of Exclusion for Extraterritorial Income

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 held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

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

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

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

Description of Proposal

The provision repeals the ETI exclusion. For transactions prior to 2005, taxpayers retain 100 percent of their ETI benefits. For transactions after 2004, the provision provides taxpayers with 80 percent of their otherwise-applicable ETI benefits for transactions during 2005 and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006. However, the provision provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003 and at all times thereafter.

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

Effective Date

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

Prior Action

Modification of House bill.

B. Deduction Relating to Income Attributable to United States Production Activities

Present Law

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

Description of Proposal

In general

The proposal provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.[1] In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer and the deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income.

Qualified production activities income

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

---

[1] For purposes of this proposal, "wages" include the sum of the aggregate amounts of wages 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.

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

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

Domestic production gross receipts

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

However, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment, or (2) the transmission or distribution of electricity, natural gas, or potable water. In addition, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[6]

---

[3] 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, in determining the cost of goods sold, and 861, in determining the source of such items).

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

[5] For this purpose, construction activities include activities that are directly related to the erection of residential and commercial buildings and infrastructure.

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

"Qualifying production property" generally includes any tangible personal property, computer software, or sound recordings. "Qualified film" includes any motion picture film or videotape (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (other than compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.[7]

Under the proposal, an election under section 631(a) made by a taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

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

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

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the proposal provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives,[8] or that are marketed through cooperatives, as it

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

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

provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income).

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

Alternative minimum tax

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

Timber cutting

Under the proposal, 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.

Effective Date

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

Prior Action

Modification of House bill and Senate amendment.

TITLE II – BUSINESS TAX INCENTIVES

A. Small Business Expensing

1. Section 179 expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[9] 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.[10] In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

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

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

Under present law, an expensing election is made under rules prescribed by the Secretary.[11] Applicable Treasury regulations provide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates.[12]

---

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

[10] 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).

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

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an expensing election may be revoked only with consent of the Commissioner.[13] JGTRRA permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.[14]

Description of Proposal

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

Effective Date

The provision is effective on the date of enactment.

Prior Action

Same as the House bill.

---

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

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

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

B. Depreciation

1. Recovery period for depreciation of certain leasehold improvements

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[15] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[16] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[17] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service.[18]

---

[15] Sec. 168.

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

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

[18] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). *See, e.g., Metro National Corp v.*

Qualified leasehold improvement property

The Job Creation and Worker Assistance Act of 2002[19] ("JCWAA"), as amended by JGTRRA, generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Treatment of dispositions of leasehold improvements

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

Description of Proposal

The proposal would provide a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006.[20] The proposal requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction,[21] with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent

---

Commissioner, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

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

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

[21] Sec. 168(k).

owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Effective Date

The proposal would be effective for property placed in service after the date of enactment.

Prior Action

Same as House bill.

2. Recovery period for depreciation of certain restaurant improvements

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[22] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Description of Proposal

The proposal provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.[23] For purposes of the proposal, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The proposal requires that qualified restaurant property be recovered using the straight-line method.

Effective Date

The proposal would be effective for property placed in service after the date of enactment.

---

[22] Sec. 168.

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

Prior Action

Same as House bill.

C. Community Revitalization

1. Modification of targeted areas and low-income communities designated for new markets tax credit

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[24] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is defined as a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). The Secretary may designate any area within any census tract as a low-income

[24] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

community provided that (1) the boundary is continuous, (2) the area (if it were a census tract) would otherwise satisfy the poverty rate or median income requirements, and (3) an inadequate access to investment capital exists in the area.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

Description of Proposal

The proposal modifies the Secretary's authority to designate certain areas as low-income communities to provide that the Secretary shall prescribe regulations to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under the proposal, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income. Under the proposal, a targeted population is not required to be within any census tract. The proposal also provides that a population census tract with a population of less than 2,000 shall be treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

Effective Date

The proposal regarding targeted populations is effective for designations made after the date of enactment. The proposal regarding low population tracts applies to investments made after the date of enactment.

Prior Action

Modification of Senate amendment.

2. Expansion of designated renewal community area based on 2000 census data

Present Law

Section 1400E provides for the designation of certain communities as renewal communities.[25] An area designated as a renewal community is eligible for the following tax incentives: (1) a zero-percent rate for capital gain from the sale of qualifying assets; (2) a 15-percent wage credit to employers for the first $10,000 of qualified wages; (3) a "commercial revitalization deduction" that allows taxpayers (to the extent allocated by the appropriate State agency) to deduct either (a) 50 percent of qualifying expenditures for the taxable year in which a qualified building is placed in service, or (b) all of the qualifying expenditures ratably over a 10-year period beginning with the month in which such building is placed in service; (4) an additional $35,000 of section 179 expensing for qualified property; and (5) an expansion of the work opportunity tax credit with respect to individuals who live in a renewal community.

To be designated as a renewal community, a nominated area was required to meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress. There are no geographic size limitations placed on renewal communities. Instead, the boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

The designations of renewal communities were required to be made by December 31, 2001, using 1990 census data to determine relevant populations and poverty rates.

Description of Proposal

The proposal authorizes the Secretary of Housing and Urban Development, at the request of all of the governments that nominated a renewal community, to add a contiguous census tract to a renewal community in the following circumstances. First, the renewal community, including any tract to be added, would have met the renewal community eligibility requirements at the time of the community's original nomination, and any tract to be added has a poverty rate using 2000 census data that exceeds the poverty rate of such tract using 1990 census data. Second, a tract may be added to a renewal community even if the addition of such tract to such community would have caused the community to fail one or more eligibility requirements when originally nominated using 1990 census data, provided that: (1) the renewal community after the inclusion of such tract does not have a population that exceeds 200,000 using either 1990 or 2000 census data; (2) such tract has a poverty rate of at least 20 percent using 2000 census data;

[25] Section 1400E was added by section 101(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

and (3) such tract has a poverty rate using 2000 census data that exceeds the poverty rate of such tract using 1990 census data. Census tracts that did not have a poverty rate determined by the Bureau of the Census using 1990 data may be added to an existing renewal community without satisfying requirement (3) above. Third, a tract may be added to an existing renewal community if such tract: (1) has no population using 2000 census data or no poverty rate for such tract is determined by the Bureau of the Census using 2000 census data; (2) such tract is one of general distress; and (3) the renewal community, including such tract, is within the jurisdiction of one or more local governments and has a continuous boundary.

Effective Date

The proposal is effective as if included in the amendments made by section 101 of the Community Renewal Tax Relief Act of 2000.

Prior Action

Modification of Senate amendment.

3. Modification of income requirement for census tracts within high migration rural counties for new markets tax credit

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[26] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all

[26] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is defined as a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). The Secretary may designate any area within any census tract as a low-income community provided that (1) the boundary is continuous, (2) the area (if it were a census tract) would otherwise satisfy the poverty rate or median income requirements, and (3) an inadequate access to investment capital exists in the area.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

Description of Proposal

The proposal provides a special low-income test for high migration rural counties. Under the proposal, in the case of a census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

Effective Date

The proposal is effective as if included in the amendment made by section 121(a) of the Community Renewal Tax Relief Act of 2000.

Prior Action

Same as Senate amendment.

D. S Corporation Reform and Simplification

Overview

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

1. Shareholders of an S corporation

Present Law

In general

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[27] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, a Domestic International Sales Corporation ("DISC") or former DISC.

Individual retirement accounts

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified

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

distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

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

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

Description of Proposal

In general

The bill provides that all family members can elect to be treated as one shareholder for purposes of determining the number of shareholders in the corporation.[28] A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this proposal, if later). Except as provided by Treasury regulations, the election for a family may be made by any family member and remains in effect until terminated.

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

Individual retirement accounts

The bill allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment of the proposal.[29]

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

[28] This rule applies whether or not the family member holds stock directly or as a beneficiary of a trust.

[29] Under the bill, the present-law rules treating S corporation stock held by a qualified retirement plan or a charity as an interest in an unrelated trade or business apply also to an IRA holding stock of a bank that is an S corporation.

connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

Effective Date

The provisions generally apply to taxable years beginning after December 31, 2004. The provision relating to IRAs takes effect on the date of enactment.

Prior Action

Similar to House bill.

2. Treatment of S corporation shareholders

(a) Electing small business trusts

Present Law

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

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

Description of Proposal

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

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

Effective Date

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

Prior Action

Same as House bill.

(b) Qualified subchapter S trusts

Present Law

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill.

(c) Transfers of losses incident to divorce, etc.

Present Law

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill.

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

Present Law

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

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

Description of Proposal

The bill provides that, in the case of a bank or bank holding company, interest income and dividends on assets required to be held by the bank or bank holding company are not treated as passive investment income for purposes of applying the excess net passive income rules.

Effective Date

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

Prior Action

Same as House bill.

4. Qualified subchapter S subsidiaries

(a) Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations

Present Law

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

Description of Proposal

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

Effective Date

The provision applies to elections and terminations after December 31, 2004.

Prior Action

Same as House bill.

(b) Information returns for qualified subchapter S subsidiaries

Present Law

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill.

5. Repayment of loan for qualifying employer securities held by an ESOP

Present Law

An employee stock ownership plan (an "ESOP") is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[30] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property between a plan and a disqualified person, (2) the lending of money or other extension of credit between a plan and a disqualified person, and (3) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.[31] In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer securities held by the ESOP are used to repay the loan. The employer securities are held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[32] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[33] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.[34]

---

[30] Sec. 4975.

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

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

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

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

Effective for taxable years beginning after December 31, 1997, a qualified retirement plan (including an ESOP) may be a shareholder of an S corporation.[35] As a result, an S corporation may maintain an ESOP.

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment with Senate effective date.

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

E. Other Business Incentives

1. Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels

Present Law

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

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

In both cases, the 4.3-cents-per-gallon excise tax rates are permanent. The .1 cent LUST Trust Fund tax is scheduled to expire after March 31, 2005.

Description of Proposal

The 4.3-cents-per-gallon General Fund excise tax rates on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system is repealed over a prescribed phase-out period. The 4.3-cent-per-gallon tax is reduced by 1 cent per gallon in calendar year 2005. The reduction is 2 cents per gallon in calendar years 2006 and 2007; 3 cents per gallon in calendar years 2008 and 2009; and 4.3 cents thereafter. Thus, the tax would be fully repealed effective January 1, 2010.

Effective Date

The proposal would be effective on January 1, 2005.

Prior Action

Modification of Senate amendment.

2. Modification of application of income forecast method of depreciation

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets

constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Income forecast method of depreciation

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

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

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

Description of Proposal

The proposal would clarify 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 proposal also would clarify that

the income from the property to be taken into account under the income forecast method is the gross income from such property.

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

In addition, the proposal would clarify that, in the case of property eligible for the income forecast method that the holding in the *Associated Patentees*[36] decision will continue to constitute a valid method. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid as under the *Associated Patentees* decision. This may be done on a property-by-property basis and shall be applied consistently with respect to a given property thereafter. The provision also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective Date

The proposal would apply 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.

Prior Action

Same as Senate amendment.

3. Improvements related to real estate investment trusts

Present Law

In general

Real estate investment trusts ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

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

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

Organizational structure requirements

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

Income requirements

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

Qualified rental income

Amounts received as impermissible “tenant services income” are not treated as rents from real property.[37] In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property.[38] Special rules also permit amounts to be received from certain “foreclosure property” treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[39] An exception applies to rents received from a taxable REIT subsidiary (“TRS”) (described further below) if at least 90

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

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

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

percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[40]

Certain hedging instruments

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

Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-percent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured by the greater of the amount by which 90 percent [41] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[42]

Asset requirements

75-percent asset test

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

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or

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

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

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

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

"Straight debt" exception

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S)[43] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if : 1) the issuer is an individual, 2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or 3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt for purposes of the REIT provision [44] is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and (ii) there is no convertibility (directly or indirectly) into stock.

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

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

Special rules for Taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a real estate investment trust[45] 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. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting

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

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

[45] 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).

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.[46]

Rents subject to the 100 percent excise tax do not include rents for services of a TRS that are for services customarily furnished or rendered in connection with the rental of real property.

They also do not include rents from a TRS that are for real property or from incidental personal property provided with such real property.

Income distribution requirements

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

Consequences of failure to meet requirements

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

In the case of a failure to meet the source of income requirements, if the failure is due to reasonable cause and not to willful neglect, the REIT may continue its REIT status if it pays the disallowed income as a tax to the Treasury.[47]

There is no similar provision that allows a REIT to pay a penalty and avoid disqualification in the case of other qualification failures.

A REIT may make a deficiency dividend after a determination is made that it has not distributed the correct amount of its income, and avoid disqualification. The Code provides only for determinations involving a controversy with the IRS and does not provide for a REIT to make such a distribution on its own initiative. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the

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

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

Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

Description of Proposal

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

Straight debt modification

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

Straight debt securities

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

Special rules are provided permitting certain contingencies for purposes of the REIT provision. Any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that the time of payment of such interest or principal is subject to a contingency, but only if one of several factors applies. The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity, but only if (i) any such contingency does not exceed the greater of ¼ of one percent or five percent of the annual yield to maturity, or (ii) neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

Also, the time or amount of any payment is permitted to be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary commercial practice.[48]

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

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if

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

the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than one percent of the issuer's outstanding securities.

Other securities

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

Safe harbor testing date for certain rents

The proposal provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a TRS to be treated as qualified rental income for purposes of the income tests.[49]

Customary services exception

The proposal prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[50] or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments would be free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

Hedging rules

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce interest rate risks are prospectively conformed to the rules included in section 1221.

---

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

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

95-percent gross income requirement

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

Consequences of failure to meet requirements

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

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

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a REIT may not hold securities possessing more than 10 percent of the total voting power or 10 percent of the total value of the outstanding securities of any one issuer.[51] The requirements must be satisfied each quarter.

The proposal provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) one percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[52]

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

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

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

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

is prescribed by the Treasury (or the requirements of the rules are otherwise met within such period), and (iv) the REIT pays a tax on the failure.

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

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

Conforming reasonable cause and reporting standard for failures of income tests

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

Other failures

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

Taxes and penalties paid deducted from amount required to be distributed

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

Expansion of deficiency dividend procedure

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

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 2000.

However, some of the provisions are effective for taxable years beginning after the date of enactment. These are: the new “look through” rules determining a REIT partner’s share of partnership securities for purposes of the “straight debt” rules; the provision changing the 90-

percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-percent of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services, and the new rules for correction of certain failures to satisfy the REIT requirements.

Prior Action

Same as House bill.

4. .Special rules for certain film and television production

Present Law

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

Description of Proposal

The proposal would provide an election to deduct the cost of qualifying film and television productions in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[53] The proposal applies only to qualifying film or television productions the aggregate cost of which does not exceed $15 million.[54] This

[53] 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.

threshold is increased $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.

The proposal defines a qualified film or television production as any production of a motion picture (whether released theatrically or directly to video cassette or any other format); 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.[55] 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.

Effective Date

The proposal would be effective for qualifying productions commencing after the date of enactment and sunsets for qualifying productions commencing after December 31, 2008. For this purpose, a production is treated as commencing on the first date of principal photography.

Prior Action

Modification of Senate amendment.

5. Provide a tax credit for maintenance of railroad track

Present Law

There is no provision that provides for a railroad track maintenance tax credit.

Description of Proposal

The proposal would provide a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred in a taxable year by eligible taxpayers. The credit is limited to the product of $3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer as of the close of it's taxable year. Qualified railroad track maintenance expenditures are defined as amounts expended (whether of not chargeable to a capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad. An eligible taxpayer is defined as: (1) any Class II or Class III railroad; and (2) any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to such person. The taxpayer's basis in railroad track is reduced by the amount of the

[54] In the case of a film which is co-produced, the $15 million threshold is applied against aggregate cost of the production to all owners. 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.

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

credit for which this credit is allowed. No portion of the credit may be carried back to any taxable year beginning before January 1, 2005. Other rules apply.

This credit applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

Effective Date

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

Prior Action

Modification of Senate amendment.

6. Suspension of occupational taxes relating to distilled spirits, wine, and beer

Present Law

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

Producers:[56]	
Distilled spirits and wines (sec. 5081)	$1,000 per year, per premise
Brewers (sec. 5091)	$1,000 per year, per premise
Wholesale dealers (sec. 5111):	
Liquors, wines, or beer	$500 per year
Retail dealers (sec. 5121):	
Liquors, wines, or beer	$250 per year
Nonbeverage use of distilled spirits (sec. 5131):	$500 per year
Industrial use of distilled spirits (sec. 5276):	$250 per year

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.[57] A delegate of the Secretary of the Treasury is authorized to

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

[57] Secs. 5114, 5124.

inspect the records of any dealer during business hours.[58] There are penalties for failing to comply with the recordkeeping requirements.[59]

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

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

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

(3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[60]

In addition, a limited retail dealer (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in liquors.[61]

Violation of this restriction is punishable by $1,000 fine, imprisonment of one year, or both.[62] A violation also makes the alcohol subject to seizure and forfeiture.[63]

Description of Proposal

Under the proposal, the special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2005 through June 30, 2008. Present law recordkeeping and registration requirements will continue to apply, notwithstanding the suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements, except that a limited retail dealer may purchase distilled spirits for resale from a retail dealer in liquors, as permitted under present law.

---

[58] Sec. 5146.

[59] Sec. 5603.

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

[61] Sec. 5117(b).

[62] Sec. 5687.

[63] Sec. 7302.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Same as House bill except for effective date.

7. Modification of unrelated business income limitation on investment in certain small business investment companies

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

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

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

Description of Proposal

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

United States) own, in the aggregate, 50 percent or more of the capital or profits interest in such company.

Effective Date

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

Prior Action

Same as House bill except for effective date.

8. Election to determine taxable income from certain international shipping activities using per ton rate

Present Law

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

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

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

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

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

Description of Proposal

In general

The proposal generally allows corporations to elect a "tonnage tax" in lieu of the U.S. corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities, and electing corporations are only subject to tax on qualifying shipping activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels. However, an electing corporation is only subject to the tonnage tax to the extent its taxable income from qualifying shipping activities would otherwise have been subject to tax under sections 11, 55, 882, 887, or 1201(a). Consequently, a foreign corporation is not subject to tax under the tonnage tax regime to the extent its income from qualifying shipping activities is subject to an exclusion for certain shipping operations by foreign corporations pursuant to section 883(a)(1) or pursuant to a treaty obligation of the United States.

Notional shipping income

An electing corporation's notional shipping income is the sum of the taxable income from each of its qualifying vessels. The taxable income from each qualifying vessel is the product of (1) the daily notional taxable income[64] from the operation of the qualifying vessel in United States foreign trade,[65] and (2) the number of days during the taxable year that the electing entity operated such vessel as a qualifying vessel in U.S. foreign trade. A "qualifying vessel" is described as a self-propelled U.S.-flag vessel of not less than 10,000 deadweight tons used exclusively in U.S. foreign trade.

Items not subject to corporate income tax

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

Core qualifying activities consist of the operation of qualifying vessels in U.S. foreign trade. Secondary activities generally consist of the active management or operation of vessels in

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

[65] "U.S. foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. As a general rule, the temporary operation in the U.S. domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel is disregarded.

U.S. foreign trade and provisions for vessel, container and cargo-related facilities, other activities of the electing corporation and other members of its group that are an integral part of its business of operating qualifying vessels in United States foreign trade, or such other activities as may be prescribed by the Secretary. Incidental activities are activities that are incidental to core qualifying activities and are not qualifying secondary activities.

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

Allocation of credits, income and deductions

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

Dispositions of qualifying vessels

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

Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.[66] Special rules apply in the context of corporate partners in pass-through entities.

Election

Generally, any qualifying vessel operator may elect into the tonnage tax regime and such election is made in the form prescribed by Treasury. An election is only effective if made before

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

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

Effective Date

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

Prior Action

Modification of House bill.

F. Stock Options and Employee Stock Purchase Plan Stock Options

1. Exclusion of incentive stock options and employee stock purchase plan stock options from wages

Present Law

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[67]

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

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[68] The applicable Code provisions[69] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option.

There has been uncertainty in the past as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[70]

Description of Proposal

The proposal provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the proposal,

---

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

[68] Secs. 3101, 3111 and 3301.

[69] Secs. 3121 and 3306.

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

FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[71] The proposal also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

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

Effective Date

The proposal is effective for stock acquired pursuant to options exercised after the date of enactment.

Prior Action

Same as House bill.

[71] The proposal also provides a similar exclusion under the Railroad Retirement Tax Act.

TITLE III – AGRICULTURAL TAX RELIEF AND INCENTIVES

A. Volumetric Ethanol Excise Tax Credit

1. Incentives for alcohol and biodiesel fuel mixtures

Present Law

Alcohol fuels income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2007.[72]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[73]) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the blender as fuel, or used as fuel by the blender in producing the mixture. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.[74]

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

The credits that comprise the alcohol fuels tax credit are includible in income. The credit may not be used to offset alternative minimum tax liability. The credit is treated as a general

---

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

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

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

business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally.

Excise tax reductions for alcohol mixture fuels

Generally, motor fuels tax rates are as follows[75]:

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

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

Gasohol

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

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2004, the following reduced rates apply to gasohol:[76]

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

Reduced excise tax rates also apply when gasoline is being purchased for the production of "gasohol." When gasoline is purchased for blending into gasohol, the rates above are multiplied by a fraction (*e.g.*, 10/9 for 10-percent gasohol) so that the increased volume of motor fuel will be subject to tax. The reduced tax rates apply if the person liable for the tax is registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or

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

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

entering the gasoline or (2) gasoline is sold upon its removal or entry and such person has an unexpired certificate from the buyer and has no reason to believe the certificate is false.[77]

Qualified methanol and ethanol fuels

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.[78] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2004 is 13.15 cents. From January 1, 2005, through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.[79]

Alcohol produced from natural gas

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.[80] For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other cases, the rate is 11.4 cents per gallon. After September 30, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

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

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

---

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

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

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

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

Aviation fuel

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.[81] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[82] In the case of 10 percent ethanol mixtures, for any sale or use during 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007. [83]

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

Refunds and payments

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

Ethyl tertiary butyl ether (ETBE)

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

Highway Trust Fund

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per

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

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

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

gallon of the tax imposed is retained in the General Fund.[84] In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.[85] For Fiscal Year 2004, the Highway Trust Fund is credited with the tax that was retained by the General Fund.

Biodiesel

If biodiesel is used in the production of blended taxable fuel, the Code imposes tax on the removal or sale of the blended taxable fuel.[86] In addition, the Code imposes tax on any liquid other than gasoline sold for use or used as a fuel in a diesel-powered highway vehicle or diesel-powered train unless tax was previously imposed and not refunded or credited.[87] If biodiesel that was not previously taxed or exempt is sold for use or used as a fuel in a diesel-powered highway vehicle or a diesel-powered train, tax is imposed.[88] There are no reduced excise tax rates for biodiesel.

Description of Proposal

Overview

The provision eliminates reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on alcohol-blended fuels (18.3 cents per gallon on gasoline blends and 24.3 cents per gallon of diesel blended fuel). In place of reduced rates, the provision creates two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.[89] The sum of these credits may be taken against the tax imposed on taxable fuels (by

---

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

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

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

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

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

[89] Although eligible mixtures are defined as those (1) sold for use or used as a fuel by the taxpayer producing the mixture or (2) removed from the refinery by a person producing the mixture, the credit for the alcohol or biodiesel used to produce such a mixture may be claimed only once. Thus, if the person selling the mixture is also the same person removing it from the

section 4081). The provision allows taxpayers to file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture. The amount of the excise tax credit with respect to any alcohol or biodiesel is reduced to take into account the benefit of any payments with respect to such alcohol or biodiesel. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit or biodiesel fuel mixture credit is claimed with respect to alcohol or biodiesel used in the production of any alcohol or biodiesel mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The provision eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund. The provision also extends the present-law alcohol fuels income tax credit through December 31, 2010.

Alcohol fuel mixture excise tax credit

The provision eliminates the reduced rates of excise tax for most alcohol-blended fuels. [90] Under the provision, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture.

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

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and a taxable fuel that is (1) sold for use or used as a fuel by the taxpayer producing the mixture or (2) removed from the refinery by a person producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Taxable fuel is gasoline, diesel, and kerosene.[91]

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

---

refinery, the credit is available only once with respect to the alcohol or biodiesel contained in the mixture.

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

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

Biodiesel mixture excise tax credit

The proposal provides an excise tax credit for biodiesel mixtures.[92] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is sold for use or used by the taxpayer producing such mixture as a fuel. In the case of agri-biodiesel, the amount of the credit is $1.00 per gallon and applies only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the agri-biodiesel that identifies the product produced.

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

Payments with respect to qualified alcohol and biodiesel fuel mixtures

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

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

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

Alcohol fuel subsidies borne by General Fund

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

Alcohol fuels income tax credit

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

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

Effective Dates

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

Prior Action

Modification of House bill and Senate amendment.

2. Biodiesel income tax credit

Present Law

No income tax credit or excise tax rate reduction is provided for biodiesel fuels under present law. However, a 52-cents-per-gallon income tax credit (the "alcohol fuels credit") is allowed for ethanol and methanol (derived from renewable sources) when the alcohol is used as a highway motor fuel. Registered blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with alcohol. These present law provisions are scheduled to expire in 2007.

Description of Proposal

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

The proposal provides a new income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed above. The proposal does not apply to fuel sold or used after December 31, 2005.

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

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the

taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

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

Later separation or failure to use as fuel

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

Effective Date

The biodiesel fuel income tax credit proposal is effective for fuel produced, and sold or used after December 31, 2004, in taxable years ending after such date.

3. Information reporting for persons claiming certain tax benefits

Present Law

The Code provides an income tax credit for each gallon of ethanol and methanol derived from renewable sources (*e.g.*, biomass) used or sold as a fuel, or used to produce a qualified alcohol fuel mixture, such as gasohol. The amount of the credit is equal to 52 cents per gallon (ethanol)[93] and 60 cents per gallon (methanol).[94] This tax credit is provided to blenders of the alcohols with other taxable fuels, or to the retail sellers of unblended alcohol fuels. Part or all of the benefits of the income tax credit may be claimed through reduced excise taxes paid, either in reduced-tax sales or by expedited blender refunds on fully taxed sales of gasoline to obtain the benefit of the reduced rates. The amount of the income tax credit determined with respect to any alcohol is reduced to take into account any benefit provided by the reduced excise tax rates. To obtain a partial refund on fully taxed gasoline, the following requirements apply: (1) the claim must be for gasohol sold or used during a period of at least one week, (2) the claim must be for at least $200, and (3) the claim must be filed by the last day of the first quarter following the

[93] The 52-cents-per-gallon credit is scheduled to decline to 51 cents per gallon beginning in calendar year 2005. The credit is scheduled to expire after the earlier of (1) expiration of the Highway Trust Fund excise taxes or (2) December 31, 2007.

[94] Ethanol produced by certain "small producers" is eligible for an additional producer tax credit of 10 cents per gallon. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons and whose annual production does not exceed 15 million gallons.

earliest quarter included in the claim. If the blender cannot meet these requirements, the blender must claim a credit on the blender's income tax return.

Description of Proposal

The proposal requires persons claiming the Code benefits related to alcohol fuels and biodiesel fuels to provide such information related to such benefits and the coordination of such benefits as the Secretary may require to ensure the proper administration and use of such benefits. The Secretary may deny, revoke or suspend the registration of any person to enforce this requirement.

Effective Date

The proposal is effective January 1, 2005.

Prior Action

Same as the Senate amendment, except for the effective date.

B. Agriculture Incentives

1. Special rules for livestock sold on account of weather-related conditions

Present Law

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

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

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

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

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

Description of Proposal

The proposal would extend the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized.

The extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than three years. Also, for property eligible for the provision's extended replacement period, the provision provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

Effective Date

The proposal would be effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

Prior Action

Same as House bill.

2. Payment of dividends on stock of cooperatives without reducing patronage dividends

Present Law

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

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[95] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

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

Description of Proposal

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

Effective Date

The proposal is effective for distributions made in taxable years beginning after the date of enactment.

Prior Action

Same as Senate amendment.

3. Modifications to small producer ethanol credit

Present Law

Small producer credit

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

Taxation of cooperatives and their patrons

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

Description of Proposal

The proposal allows cooperatives to elect to pass-through the small ethanol producer credits to its patrons. The credit is to be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for such taxable year.

The amount of the credit not apportioned to patrons is included in the taxable year for the organization. The amount of the credit apportioned to patrons is to be included in the first taxable year of each patron ending on or after the last day of the payment period for the taxable year of the organization, or, if earlier, for the taxable year of each patron ending on or after the date on which the patron receives notice from the cooperative of the apportionment.

If the amount of the credit shown on the cooperative's return for a taxable year is in excess of the actual amount of the credit for that year, the excess amount is treated as an increase in the cooperative's tax for the taxable year to the extent that such amount was not apportioned to patrons. The increase is not treated as tax imposed for purposes of determining the amount of any tax credit or for purposes of the alternative minimum tax.

Effective Date

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

Prior Action

Modification of Senate amendment.

4. Extend income averaging to farmers; coordinate farmers and fishermen income averaging and the alternative minimum tax

Present Law

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

Description of Proposal

The proposal extends to individuals engaged in the trade or business of fishing the election that is available to individual farmers to use income averaging.

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

Effective Date

The proposal applies to taxable years beginning after December 31, 2003.

Prior Action

Similar to House bill.

5. Capital gain treatment to apply to outright sales of timber by landowner

Present Law

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

Descripion of Proposal

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment, with House effective date.

6. Modification to cooperative marketing rules to include value added processing involving animals

Present Law

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

amount of additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as Senate amendment.

7. Extension of declaratory judgment procedures to farmers' cooperative organizations

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[96] 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.

[96] 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.

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.

Description of Proposal

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

Effective Date

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

8. Modified safe harbor rules for timber REITs

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[97], other than foreclosure property.[98] 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

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

[98] 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.

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.[99]

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than five percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[100]

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[101] 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

[99] 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.

[100] 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.

[101] 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).

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.[102]

Description of Proposal

The proposal provides a safe-harbor, under which certain sales of REIT timber property will not be considered sales of property held for sale in the ordinary course of business.[103] Under the proposal a sale of a real estate asset by a REIT will not be a prohibited transaction if the following six requirements are met:

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

(2) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property (other than timberland acquisition expenditures[104]) 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;

---

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

[103] A similar safe harbor exists under present law for certain sales. Sec. 857(b)(6)(C).

[104] 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.

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

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

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

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

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

Effective Date

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

Prior Action

Same as the Senate amendment.

9. Expensing of reforestation expenditures

Present Law

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

Description of Proposal

The proposal permits up to $10,000 of qualified reforestation expenditures to be deducted in the year paid or incurred (i.e., expensed). The proposal also repeals the reforestation tax credit.

Effective Date

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

Prior Action

Same as the Senate amendment.

C. Other Incentives

1. Net income from publicly traded partnerships treated as qualifying income of regulated investment company

Present Law

Treatment of RICs

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

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

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

Treatment of publicly traded partnerships

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation (sec. 7704(a)), but an exception to corporate treatment is provided if 90 percent

or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income (sec. 7704(c) and (d)).

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

Description of Proposal

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

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

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

2. Simplification of excise tax imposed on bows and arrows

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.[105] An excise tax of 12.4 percent

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

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).[106] 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).[107]

Description of Proposal

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[108] The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the 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.[109] Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

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

Prior Action

Same as House bill and Senate amendment with Senate effective date.

---

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

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

[108] 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.

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

3. Reduce rate of excise tax on fishing tackle boxes to three percent

Present Law

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

Description of Proposal

The proposal reduces the rate of excise tax imposed on fishing tackle boxes to three percent.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

Prior Action

Modification of House bill.

4. Repeal of excise tax on sonar devices suitable for finding fish

Present Law

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[110] A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.[111] Further, the tax imposed on the sale of sonar devices suitable for finding fish is limited to $30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.[112]

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

---

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

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

[112] Sec. 4162(b).

Description of Proposal

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

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2004.

Prior Action

Same as House bill.

5. Charitable contribution deduction for certain expenses in support of Native Alaskan subsistence whaling

Present Law

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

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution.[113] Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

Description of Proposal

The proposal allows individuals to claim a deduction under section 170 not exceeding $10,000 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction is available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction is available for reasonable and necessary expenses paid by the taxpayer during the taxable year for: (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities; (2) the supplying of food for the crew and other provisions for carrying out such activities; and (3) the storage and distribution of the catch from such activities. The proposal provides that the Secretary shall issue guidance requiring that the taxpayer substantiate whaling expenses for which a deduction is claimed, including by maintaining appropriate written records

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

with respect to the time, place, date, amount, and nature of the expense, as well as the taxpayer's eligibility for the deduction, and that (to the extent provided by the Secretary) such substantiation be provided as part of the taxpayer's income tax return.

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

Effective Date

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

Prior Action

Modification of House bill.

6. Extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Thirty-percent additional first year depreciation deduction

JCWAA allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[114] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[115] The basis of the property and the depreciation

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

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

allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are generally no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.[116]

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[117] Second, the original use[118] of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must acquire the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005.

An extension of the placed-in-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[119] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005.[120] For property eligible for the extended

---

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

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

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

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

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

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

placed-in-service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2005 ("progress expenditures") is eligible for the additional first-year depreciation.[121]

Fifty-percent additional first year depreciation

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

In order to qualify, the property must be acquired after May 5, 2003 and before January 1, 2005, and no binding written contract for the acquisition can be in effect before May 6, 2003.[122] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed-in-service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2005 are eligible for the additional first-year depreciation.[123]

Description of Proposal

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

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

---

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

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

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

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

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

(d) be purchased[124] by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of ten percent of the cost or $100,000; and

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment, with House effective date.

7. Special placed in service rule for bonus depreciation for certain property subject to syndication

Present Law

Section 101 of JCWAA provides generally for 30-percent additional first-year depreciation, and provides a binding contract rule in determining property that qualifies for it. The requirements that must be satisfied in order for property to qualify include that (1) the original use of the property must commence with the taxpayer on or after September 11, 2001, (2) the taxpayer must acquire the property after September 10, 2001 and before September 11, 2004, and (3) no binding written contract for the acquisition of the property is in effect before September 11, 2001 (or, in the case of self-constructed property, manufacture, construction, or production of the property does not begin before September 11, 2001). In addition, JCWAA provides a special rule in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. JCWAA did not specifically address the syndication of a lease by the lessor.

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

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

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

Description of Proposal

The proposal would provide a special rule in the case of multiple units of property subject to the same lease. In such cases, property will qualify as placed in service on the date of sale if it is sold within three months after the final unit is placed in service, so long as the period between the time the first and last units are placed in service does not exceed 12 months.

Effective Date

The proposal would be effective for property sold after June 4, 2004.

Prior Action

Modification of House bill and Senate amendment due to the enactment of H.R. 1308. Other than the duplicative clauses that were removed due to enactment of H.R. 1308, the proposal is the same as the House bill and the Senate amendment, with the House effective date.

8. Expensing of capital costs incurred for production in complying with environmental protection agency sulfur regulations for small refiners

Present Law

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

Description of Proposal

The proposal permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). Qualifying expenditures are those expenditures paid or incurred with respect to a facility beginning January 1, 2003, and ending the earlier of the date that is one year after the date on which the taxpayer must comply with applicable EPA regulation or December 31, 2009.

For these purposes a small business refiner is a taxpayer who is within the business of refining petroleum products employs not more than 1,500 employees directly in refining and has less than 205,000 barrels per day (average) of total refinery capacity. In any case in which refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, capacity is measured by reference to the average daily output of refined product. The deduction is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

Effective Date

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

Prior Action

Same as Senate amendment.

9. Credit for small refiners for production of diesel fuel in compliance with environmental protection agency sulfur regulations for small refiners

Present Law

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

Description of Proposal

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

For these purposes a small business refiner is a taxpayer who is within the business of refining petroleum products employs not more than 1,500 employees directly in refining and has less than 205,000 barrels per day (average) of total refinery capacity. In any case in which refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, capacity is measured by reference to the average daily output of

refined product. The amount of credit a taxpayer may claim is reduced, *pro rata*, for taxpayers with capacity in excess of 155,000 barrels per day.

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

Effective Date

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

Prior Action

Same as Senate amendment

TITLE IV – TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES

A. Interest Expense Allocation Rules

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.[125] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

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

Definition of affiliated group -- consolidated return rules

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

---

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

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

Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[126] 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.

Description of Proposal

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

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

(i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[127] 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.[128]

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)[129] as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[130] 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.

---

[127] 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.

[128] 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.

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

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

In addition, if an affiliated group elects to apply the new elective rules based on worldwide fungibility, the present-law rules regarding the treatment of tax-exempt assets and the basis of stock in nonaffiliated 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.[131] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

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

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

B. Recharacterize Overall Domestic Loss

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.

Description of Proposal

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.

Prior Action

Same as House bill and Senate amendment.

C. Apply Look-Through Rules for Dividends from Noncontrolled Section 902 Corporations

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).[132] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach).

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

Description of Proposal

The 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.[133] If the Treasury Secretary determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 company to the proper foreign tax credit

[132] 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.

[133] 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.

limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes.[134]

Effective Date

The provision is effective for taxable years beginning after December 31, 2002. The provision also provides transition rules regarding the use of pre-effective-date foreign tax credits associated with a 10/50-company separate limitation category in post-effective-date years. Look-through principles similar to those applicable to post-effective-date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. The provision allows the Treasury Secretary to issue regulations addressing the carryback of foreign tax credits associated with a dividend from a 10/50 company to pre-effective-date years.

Prior Action

Same as House bill and Senate amendment.

[134] It is anticipated that the Treasury Secretary will reconsider the operation of the foreign tax credit regulations to ensure that the high-tax income rules apply appropriately to dividends treated as passive category income because of inadequate substantiation.

D. Foreign Tax Credit Baskets and "Base Differences"

Present Law

In general

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[135] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). In addition, a number of other provisions of the Code and U.S. tax treaties effectively create additional separate limitations in certain circumstances.[136]

Financial services income

In general, the term "financial services income" includes income received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, if the income is derived in the active conduct of a banking, financing or similar

---

[135] Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies that are not passive foreign investment companies (for pre-2003 earnings and profits). Under section 304 of the bill, these dividends are subject to a look-through approach, irrespective of when the underlying earnings and profits arose.

[136] *See, e.g.*, sec. 56(g)(4)(C)(iii)(IV) (relating to certain dividends from corporations eligible for the sec. 936 credit); sec. 245(a)(10) (relating to certain dividends treated as foreign source under treaties); sec. 865(h)(1)(B) (relating to certain gains from stock and intangibles treated as foreign source under treaties); sec. 901(j)(1)(B) (relating to income from certain specified countries); and sec. 904(g)(10)(A) (relating to interest, dividends, and certain other amounts derived from U.S.-owned foreign corporations and treated as foreign source under treaties).

business, or is derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business (sec. 904(d)(2)(C)). The Code also provides that financial services income includes income, received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, of a kind which would generally be insurance income (as defined in section 953(a)), among other items.

Treasury regulations provide that a person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any year if for that year at least 80 percent of its gross income is "active financing income."[137] The regulations further provide that a corporation that is not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business under the preceding definition can derive financial services income if the corporation is a member of an affiliated group (as defined in section 1504(a), but expanded to include foreign corporations) that, as a whole, meets the regulatory test of being "predominantly engaged."[138] In determining whether an affiliated group is "predominantly engaged," only the income of members of the group that are U.S. corporations, or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of the total voting power and value of the stock, are counted.

"Base difference" items

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[139] 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.[140]

Description of Proposal

In general

The provision generally reduces the number of foreign tax credit limitation categories to two: passive category income and general category income. Other income is included in one of the two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation category, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation

[137] Treas. Reg. sec. 1.904-4(e)(3)(i) and (2)(i).

[138] Treas. Reg. sec. 1.904-4(e)(3)(ii).

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

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

category. The provision does not affect the separate computation of foreign tax credit limitations under special provisions of the Code relating to, for example, treaty-based sourcing rules or specified countries under section 901(j).

Financial services income

In the case of a member of a financial services group or any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business, the provision treats income meeting the definition of financial services income as general category income. Under the provision, a financial services group is an affiliated group that is predominantly engaged in the active conduct of a banking, insurance, financing or similar business. For this purpose, the definition of an affiliated group under section 1504(a) is applied, but expanded to include certain insurance companies (without regard to whether such companies are covered by an election under section 1504(c)(2)) and foreign corporations. In determining whether such a group is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are U.S. corporations or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of total voting power and value of the stock are taken into account.

The provision does not alter the present law interpretation of what it means to be a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business."[141] Thus, other provisions of the Code that rely on this same concept of a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" are not affected by the provision. For example, under the "accumulated deficit rule" of section 952(c)(1)(B), subpart F income inclusions of a U.S. shareholder attributable to a "qualified activity" of a controlled foreign corporation may be reduced by the amount of the U.S. shareholder's pro rata share of certain prior year deficits attributable to the same qualified activity. In the case of a qualified financial institution, qualified activity consists of any activity giving rise to foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Similarly, in the case of a qualified insurance company, qualified activity consists of activity giving rise to insurance income or foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. For this purpose, "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" is defined under present law by reference to the use of the term for purposes of the separate foreign tax credit limitations.[142] The present-law meaning of "predominantly engaged" for purposes of section 952(c)(1)(B) remains unchanged under the provision.

---

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

[142] *See* H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-621 (1986); Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 984 (1987).

The provision requires the Treasury Secretary to specify the treatment of financial services income received or accrued by pass-through entities that are not members of a financial services group. The Committee expects these regulations to be generally consistent with regulations currently in effect.

"Base difference" items

Creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed on general limitation income.

Any such taxes arising in taxable years beginning after December 31, 2004, but before January 1, 2007 (when the number of limitation categories is reduced to two), are treated as imposed on either general limitation income or financial services income, at the taxpayer's election. Once made, this election applies to all such taxes for the taxable years described above and is revocable only with the consent of the Treasury Secretary.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 2006. Taxes paid or accrued in a taxable year beginning before January 1, 2007, and carried to any subsequent taxable year are treated as if this provision were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories, as appropriate. The Treasury Secretary is given authority to provide by regulations for the allocation of income with respect to taxes carried back to pre-effective-date years (in which more than two limitation categories are in effect).

The rules dealing with "base difference" items are effective for taxes arising in taxable years beginning after December 31, 2004.

Prior Action

Modification of House bill and Senate amendment.

E. Attribution of Stock Ownership Through Partnerships In Determining Section 902 and 960 Credits

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.[143] In Rev. Rul. 71-141,[144] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations

[143] 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.

[144] 1971-1 C.B. 211.

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

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[145] In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, uncertainty remains regarding whether a domestic corporation owning 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).

Description of Proposal

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. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The provision also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

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

F. Foreign Tax Credit Treatment of Deemed Payments Under Section 367(d) of the Code

Present Law

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

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[146]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[147] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[148]

Description of Proposal

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).

---

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

[147] Sec. 904(d).

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

Prior Action

Same as House bill and Senate amendment.

G. United States Property Not to Include Certain Assets of Controlled Foreign Corporations

Present Law

In general, the subpart F rules[149] 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.[150]

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.[151] 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.[152] 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.[153]

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

---

[149] Secs. 951-964.

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

[151] Sec. 956(a).

[152] Secs. 956 and 959.

[153] 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.[154]

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.[155]

Description of Proposal

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

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

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

Effective Date

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

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

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

Prior Action

Same as House bill and Senate amendment.

H. Translation of Foreign Taxes

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.[156] 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.[157]

Description of Proposal

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the proposal provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[158] Any election under the proposal applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The proposal authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

The proposal provides that the election does not apply to regulated investment companies that take into account income on an accrual basis. Instead, the proposal provides that foreign income taxes paid or accrued by a regulated investment company with respect to such income are translated into U.S. dollar amounts using the exchange rate as of the date the income accrues.

---

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

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

[158] 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.

Effective Date

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

Prior Action

Modification of House bill and Senate amendment.

I. Eliminate Secondary Withholding Tax with Respect to Dividends Paid by Certain Foreign Corporations

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.

Description of Proposal

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.

Prior Action

Same as House bill and Senate amendment.

J. Provide Equal Treatment for Interest Paid by Foreign Partnerships and Foreign Corporations

Present Law

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[159] 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.[160] 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).[161]

Description of Proposal

The proposal treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The proposal applies only to foreign partnerships that are predominantly engaged in the active conduct of a trade or business outside the United States.

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

---

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

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

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

K. Treatment of Certain Dividends of Regulated Investment Companies

Present Law

Regulated investment companies

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

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

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

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

U.S. source investment income of foreign persons

In general

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

dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

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

Capital gains

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

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

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[162] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

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

Description of Proposal

In general

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

Interest-related dividends

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

---

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

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

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

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

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

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

Short-term capital gain dividends

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

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

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

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

Estate tax treatment

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

certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The proposal generally applies to dividends with respect to taxable years of RICs beginning after December 31, 2004 and before January 1, 2008. With respect to the treatment of a RIC for estate tax purposes, the proposal applies to estates of decedents dying after December 31, 2004 and before January 1, 2008. With respect to the treatment of RICs under section 897 (relating to U.S. real property interests), the proposal is effective after December 31, 2004 and before January 1, 2008.

Prior Action

Modification of House bill and Senate amendment.

L. Look-through Treatment Under Subpart F for Sales of Partnership Interests

Present Law

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

M. Repeal of Foreign Personal Holding Company Rules and Foreign Investment Company Rules

Present Law

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

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

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

N. Determination of Foreign Personal Holding Company Income with Respect to Transactions in Commodities

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.[163] 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

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

commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[164]

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).[165] 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.[166]

Description of Proposal

The proposal modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the proposal, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of the proposal, 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).[167]

---

[164] 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)).

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

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

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

The proposal also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the proposal, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[168]

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

Prior Action

Same as House bill and Senate amendment.

[168] 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 provision) continue to apply.

O. Modifications to Treatment of Aircraft Leasing and Shipping Income

Present Law

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

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries. In addition, foreign base company shipping income includes dividends and interest that a CFC receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a CFC's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation.

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

Subpart F foreign personal holding company income does not include rents and royalties received by a CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). The determination of whether rents or royalties are derived in the active conduct of a trade or business is based on all the facts and circumstances. However, the Treasury regulations provide certain types of rents are treated as derived in the active conduct of a trade or business. These include rents derived from property that is leased as a result of the performance of marketing functions by the lessor if the lessor (through its own officers or employees located

in a foreign country) maintains and operates an organization in such country that regularly engages in the business of marketing, or marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property. An organization in a foreign country is substantial in relation to rents if the active leasing expenses[169] equal at least 25 percent of the adjusted leasing profit.[170]

Also generally excluded from subpart F foreign personal holding company income are rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC was organized (sec. 954(c)(3)). However, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Description of Proposal

The proposal repeals the subpart F rules relating to foreign base company shipping income. The proposal also amends the exception from foreign personal holding company income applicable to rents or royalties derived from unrelated persons in an active trade or business, by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. Such rents are excluded from foreign personal holding company income if the active leasing expenses comprise at least 10 percent of the profit on the lease. This proposal is to be applied in accordance with existing regulations under sec. 954(c)(2)(A) by comparing the lessor's "active leasing expenses" for its pool of leased assets to its "adjusted leasing profit."

The safe harbor will not prevent a lessor from otherwise showing that it actively carries on a trade or business. In this regard, the requirements of section 954(c)(2)(A) will be met if a lessor regularly and directly performs active and substantial marketing, remarketing, management and operational functions with respect to the leasing of an aircraft or vessel (or component engines). This will be the case regardless of whether the lessor engages in marketing of the lease as a form of financing (versus marketing the property as such) or whether the lease is classified as a finance lease or operating lease for financial accounting purposes. If a lessor acquires, from an unrelated or related party, a ship or aircraft subject to an existing FSC or ETI lease, the requirements of section 954(c)(2)(A) will be satisfied if, following the acquisition, the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property. If such a lease is transferred to a CFC lessor, it will no longer be eligible for FSC or ETI benefits.

---

[169] "Active-leasing expenses" are section 162 expenses properly allocable to rental income other than (1) deductions for compensation for personal services rendered by the lessor's shareholders or a related person, (2) deductions for rents, (3) section 167 and 168 expenses, and (4) deductions for payments to independent contractors with respect to leased property. Treas. Reg. sec. 1.954-2(c)(2)(iii).

[170] Generally, "adjusted leasing profit" is rental income less the sum of (1) rents paid or incurred by the CFC with respect to such rental income; (2) section 167 and 168 expenses with respect to such rental income; and (3) payments to independent contractors with respect to such rental income. Treas. Reg. sec. 1.954-2(c)(2)(iv).

An aircraft or vessel will be considered to be leased in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and one in a foreign country or between foreign ports (or airports), provided the aircraft or vessel is used predominantly outside the United States. An aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is located outside the United States more than 50 percent of the time during such taxable year.

The Committee expects that the Secretary of the Treasury will issue timely guidance to make conforming changes to existing regulations, including guidance that aircraft or vessel leasing activity that satisfies the requirements of section 954(c)(2)(A) shall also satisfy the requirements for avoiding income inclusion under section 956 and section 367(a).

The Committee anticipates that taxpayers now eligible for the benefits of the ETI exclusion (or the FSC provisions pursuant to the FSC Repeal and Extraterritorial Income Exclusion Act of 2000), will find it appropriate, as matter of sound business judgment, to restructure their business operations to take into account the tax law changes brought about by the proposal. The Committee notes that courts have recognized the validity of structuring operations for the purpose of obtaining the benefit of tax regimes expressly intended by Congress. The Committee intends that structuring or restructuring of operations for the purposes of adapting to the repeal of the ETI exclusion (or the FSC regime) will be considered to serve a valid business purpose and will not constitute tax avoidance, where the restructured operations conform to the requirements expressly mandated by Congress for obtaining tax benefits that remain available. For example, the Committee intends that a restructuring undertaken to transfer aircraft subject to existing FSC or ETI leases to a CFC lessor, to take advantange of the amendments made by this proposal, would serve as a valid business purpose and would not constitute tax avoidance, for purposes of determining whether a particular tax treatment (such as nonrecognition of gain) applies to such restructuring. The Committee intends, for example, that if such a restructuring meets the other requirements necessary to qualify as a "reorganization" under section 368, the transaction will also be deemed to meet the "business purpose" requirements under section 368, and thus, qualify as a reorganization under that section.

Effective Date

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

Prior Action

Same as House bill.

P. Modification of Exceptions Under Subpart F for Active Financing

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").[171]

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

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

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

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

Description of Proposal

The proposal would modify the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the proposal would provide 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 would 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 proposal would be effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Q. Ten-Year Foreign Tax Credit Carryover; One-Year Foreign Tax Credit Carryback

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.[172]

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.

Description of Proposal

The provision extends the excess foreign tax credit carryforward period to ten 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.

---

[172] Section 904(a).

Prior Action

Modification of Senate amendment.

R. Modify FIRPTA Rules for Real Estate Investment Trusts

Present Law

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

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

In general, FIRPTA provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a U.S. trade or business during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons. For these purposes, the receipt of a distribution from a REIT is treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT. These capital gains distributions from REITs generally are subject to withholding tax at a rate of 35 percent (or a lower treaty rate). In addition, the recipients of these capital gains distributions are required to file Federal income tax returns in the United States, since the recipients are treated as earning income effectively connected with a U.S. trade or business.

In 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).

Description of Proposal

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

Thus, a foreign investor is not required to file a U.S. Federal income tax return by reason of receiving such a distribution. 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 proposal applies to taxable years beginning after the date of enactment.

Prior Action

Same as Senate amendment.

S. Exclusion of Certain Horse-Racing and Dog-Racing Gambling Winnings from the Income of Nonresident Alien Individuals

Present Law

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

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[173] event taking place within the United States, the source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

[173] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

Description of Proposal

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.

Prior Action

Same as Senate amendment.

T. Limitation of Withholding on U.S.-Source Dividends Paid to Puerto Rico Corporation

Present Law

In general, dividends paid by corporations organized in the United States[174] to corporations organized outside of the United States and its possessions are subject to U.S. income tax withholding at the flat rate of 30 percent. The rate may be reduced or eliminated under a tax treaty. Dividends paid by U.S. corporations to corporations organized in certain U.S. possessions are subject to different rules.[175] 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.[176] 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.

Description of Proposal

The proposal lowers the withholding income tax rate on U.S. source dividends paid to a corporation created or organized in Puerto Rico from 30 percent to 10 percent, to create parity with the generally applicable 10 percent withholding tax imposed by Puerto Rico on dividends paid to U.S. corporations. The lower rate applies only if the same local ownership and activity

---

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

[175] 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).

[176] 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.

requirements are met that are applicable to corporations organized in other possessions receiving dividends from corporations organized in the United States. If the generally applicable 10 percent withholding tax rate imposed by Puerto Rico on dividends paid to U.S. corporations increases to greater than 10 percent, the U.S. withholding rate on dividends to Puerto Rico corporations reverts to 30 percent.

Effective Date

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

Prior Action

Modification of Senate amendment.

U. Foreign Tax Credit Under Alternative Minimum Tax

Present Law

In general

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

Foreign tax credit

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

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

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

V. Incentives to Reinvest Foreign Earnings in the United States

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, under anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral provisions in this context are the controlled foreign corporation rules of subpart F[177] and the passive foreign investment company rules.[178] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.[179]

Description of Proposal

Under the proposal, certain dividends received by a U.S. corporation from controlled foreign corporations are eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either during the taxpayer's first taxable year beginning on or after the date of enactment of the bill, or during the taxpayer's last taxable year beginning before such date.[180] Dividends received after the election period will be taxed in the normal manner under present law.

The deduction applies only to cash dividends and other cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304 (but not to amounts treated as dividends under Code sections 78, 367, or 1248). The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956. Similarly, the deduction does not apply to distributions of earnings previously taxed under subpart F, except to the extent that the subpart F inclusions result from the payment of a dividend by one controlled foreign corporation to another controlled foreign corporation within a certain chain of ownership during the election period, with the result that cash travels through a chain of controlled foreign corporations to the taxpayer within the election period. The amount of dividends eligible for the deduction is reduced by any

[177] Secs. 951-964.

[178] Secs. 1291-1298.

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

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

increase in related-party indebtedness on the part of a controlled foreign corporation occurring between October 3, 2004, and the close of the taxable year for which the deduction is being claimed, determined by treating all controlled foreign corporations with respect to which the taxpayer is a U.S. shareholder as one controlled foreign corporation. This rule is intended to prevent a taxpayer from claiming the deduction in cases in which the taxpayer itself directly or indirectly finances the payment of a dividend from a controlled foreign corporation. In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.

The deduction is subject to a number of general limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before June 30, 2003, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such five years (the "base-period average"). If the taxpayer has fewer than five such years, then all taxable years ending on or before June 30, 2003 are included in the base period.[181] Repatriation levels are determined by reference to base-period tax returns as filed, including any amended returns that were filed on or before June 30, 2003. In addition to cash dividends, dividends of property, deemed repatriations under section 956, and distributions of earnings previously taxed under subpart F are included in the base-period average.

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

Third, in order to qualify for the deduction, dividends must be described in a domestic reinvestment plan approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation. This list of permitted uses is not exclusive, and it is intended that the concept of reinvestment in the United States be construed broadly. The reinvestment plan cannot, however, designate repatriated funds for use as payment for executive

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

compensation. Dividends with respect to which the deduction is not being claimed are not required to be included in any domestic reinvestment plan.

No foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which dividends are not.[182] In other words, the taxpayer is allowed to choose which of its dividends are treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends are treated as comprising the excess eligible for the deduction (and thus entail proportional disallowance of any associated foreign tax credits). The deduction itself will have the effect of appropriately reducing the taxpayer's foreign-source income for purposes of computing the foreign tax credit limitation. No deductions are allowed for expenses that are properly allocated and apportioned to the deductible portion of any dividend.

The income attributable to the nondeductible portion of a qualifying dividend may not be offset by expenses, losses, or deductions, and the tax attributable to such income generally may not be offset by credits (other than foreign tax credits and AMT credits).[183] This tax also cannot reduce the alternative minimum tax that otherwise would be owed by the taxpayer. However, the deduction available under this provision is not treated as a preference item for purposes of computing the AMT. Thus, the deduction is allowed in computing alternative minimum taxable income notwithstanding the fact that it may not be deductible in computing earnings and profits. No deduction under sections 243 or 245 is allowed for any dividend for which a deduction is allowed under the provision.

Effective Date

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

Prior Action

Modification of House bill and Senate amendment.

---

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

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

W. Delay in Effective Date of Final Regulations Governing Exclusion of Income from International Operations of Ships and Aircraft

Present Law

Section 883 generally provides an exemption from gross income for earnings of a foreign corporation derived from the international operation of ships and aircraft if an equivalent exemption from tax is granted by the applicable foreign country to corporations organized in the United States.

Treasury has issued regulations implementing the rules of section 883 that are effective for taxable years beginning 30 days or more after August 26, 2003. The regulations provide, in general, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft shall exclude qualified income from gross income for purposes of United States Federal income taxation, provided that the corporation can satisfy certain ownership and related documentation requirements. The proposed rules explain when a foreign country is a qualified foreign country and what income is considered to be qualified income.

Description of Proposal

The proposal delays the effective date for the Treasury regulations so that they apply to taxable years of foreign corporations seeking qualified foreign corporation status beginning after September 24, 2004.

Effective Date

The proposal is effective after date of enactment.

Prior Action

Same as Senate amendment except for effective date.

X. Study of Earnings Stripping Provisions

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through certain earnings stripping transactions. These rules limit the deductibility of interest paid to certain related parties ("disqualified interest"), if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disqualified interest for these purposes also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

Description of Proposal

The proposal requires the Treasury Department to conduct a study of the earnings stripping rules, including a study of the effectiveness of these rules in preventing the shifting of income outside the United States, and whether any deficiencies in these rules have the effect of placing U.S.-based businesses at a competitive disadvantage relative to their foreign-based counterparts. This study is to include specific recommendations for improving these rules and is to be submitted to the Congress not later than June 30, 2005.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

No provision.

TITLE V – DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

Present Law

An itemized deduction is permitted for certain taxes paid, including individual income taxes, real property taxes, and personal property taxes. No itemized deduction is permitted for State or local general sales taxes.

Description of Proposal

The proposal provides that, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.

Taxpayers would possess two options with respect to the determination of the State and local sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury. The tables are to be based on average consumption by taxpayers on a State-by-State basis taking into account filing status, number of dependents, adjusted gross income and rates of State and local general sales taxation. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables would not be reflected in the tables themselves.

The term 'general sales tax' means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items would not be taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax shall not be taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction shall be allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate shall be treated as the rate of tax.

A compensating use tax with respect to an item shall be treated as a general sales tax, provided such tax is complimentary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003 and prior to January 1, 2006.

Prior Action

Modification of House bill.

TITLE VI – FAIR AND EQUITABLE TOBACCO REFORM

Present Law

The current tobacco program has two main components: a supply management component and a price support component. In addition, in 1982, Congress passed the "No-Net-Cost Tobacco Program Act"[184] that assured the tobacco program would run at no-net cost to the Federal government.

Supply management

The supply management component limits and stabilizes the quantity of tobacco marketed by farmers. This is achieved through marketing quotas. The Secretary of Agriculture raises or lowers the national marketing quota on an annual basis. The Secretary establishes the national marketing quota for each type of tobacco based upon domestic and export demand, but at a price above the government support price. The purpose of matching supply with demand is to keep the price of tobacco high. There is a secondary market in tobacco quota. Tobacco growers who do not have sufficient quota may purchase or rent one.

Support price

Given the numerous variables that affect tobacco supply and demand, marketing quotas alone have not always been able to guarantee tobacco prices. Therefore, in addition to marketing quotas, Federal support prices are established and guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the Department of Agriculture using the formula specified in the law to calculate loan levels. This system guarantees minimum prices for the different types of tobacco.

The national loan price on 2004 crop flue-cured tobacco is $1.69 per pound; the burley loan price is $1.873 per pound.

No-net-cost assessment

In 1982, Congress passed the "No-Net-Cost Tobacco Program Act." The purpose of this program is to ensure that the nonrecourse loan program is run at no-net-cost to the Federal government.

When tobacco is not contracted, it is sold at an auction sale barn. At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. When the bid does not exceed this price, the farmer may choose to be paid the loan price by a cooperative, with money borrowed from the Commodity Credit Corporation ("CCC"). In such cases, the tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for the

[184] Pub. L. No. 97-218 (1982).

CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest. If the cooperative does not recover the cost of the loan plus interest, the Secretary of Agriculture assesses growers, purchasers and importers of tobacco in order to repay the difference. All growers, purchasers and importers of tobacco participate in paying these assessments, regardless of whether or not they participate in the loan program.

The no-net-cost assessment on 2004 crop flue-cured is 10 cents per pound; the burley assessment is 2 cents per pound. The no-net-cost assessment funds are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations.

Currently, over 80 percent of growers market their tobacco through contracts with tobacco companies, and thus these growers do not participate in the loan program. However, they must still pay the no-net-cost assessment when the Secretary levies it. The remaining 20 percent of growers market their tobacco through the auction system, and are eligible for participation in the loan program. Of this group, over 60 percent have consistently participated in the loan program during the past several years.

Description of Proposal

All aspects of the Federal tobacco support program, including marketing quotas and nonrecourse marketing loans are repealed.

The proposal provides eligible quota holders $7 per pound on their basic quota allotment paid in equal installments over 10 years.

Additionally, the proposal provides eligible producers transition payments of $3 per pound based on their effective quota paid in equal installments over 10 years.

Manufacturers and importers of tobacco products will pay a quarterly assessment into a newly formed Tobacco Trust Fund. These assessments will be on the following classes of tobacco: Cigarettes, Snuff, Chewing Tobacco, Pipe Tobacco, Roll-your-own tobacco, and Cigars. Assessment allocations will then be divided into manufacturers' and importers' market share.

Funds from the Tobacco Trust Fund will be used to provide payments to quota holders and eligible producers as well as pay for program losses incurred by the U.S. Department of Agriculture.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Modification of the House bill.

TITLE VII – MISCELLANEOUS PROVISIONS

A. Brownfields Demonstration Program for Qualified Green Building and Sustainable Design Projects

Present Law

Tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds.[185] Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called ''private activity bonds.'' The term ''private person'' includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. For example, interest on bonds issued to benefit section 501(c)(3) organizations is generally tax-exempt ("qualified 501(c)(3) bonds"). Both capital expenditures and limited working capital expenditures of section 501(c)(3) organizations may be financed with qualified 501(c)(3) bonds.

In addition, States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses.[186] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, hazardous waste disposal facilities, and public educational facilities); privately owned and/or operated low-income rental housing;[187] and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local

---

[185] Sec. 103.

[186] Secs. 141(e) and 142(a).

[187] Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Generally, tax-exempt private activity bonds are subject to restrictions that do not apply to other bonds issued by State or local governments. For example, the volume of most tax-exempt private activity bonds is limited by annual volume limits.[188]

Description of Proposal

In general

The proposal creates a new category of exempt-facility bond, the qualified green building and sustainable design project bond ("qualified green bond"). A qualified green bond is defined as any bond issued as part of an issue that finances a project designated by the Secretary, after consultation with the Administrator of the Environmental Protection Agency (the "Administrator") as a green building and sustainable design project that meets the following eligibility requirements: (1) at least 75 percent of the square footage of the commercial buildings that are part of the project is registered for the U.S. Green Building Council's LEED[189] certification and is reasonably expected (at the time of designation) to meet such certification; (2) the project includes a brownfield site;[190] (3) the project receives at least $5 million dollars in specific State or local resources; and (4) the project includes at least one million square feet of building or at least 20 acres of land.

Under the proposal, qualified green bonds are not subject to the State bond volume limitations. Rather, there is a national limitation of $2 billion of bonds that the Secretary may allocate, in the aggregate, to qualified green building and sustainable design projects. Qualified green bonds may be currently refunded if certain conditions are met, but cannot be advance refunded. The authority to issue qualified green bonds terminates after September 30, 2009.

---

[188] Sec. 146.

[189] The LEED ("Leadership in Energy and Environmental Design) Green Building Rating System is a voluntary, consensus-based national standard for developing high-performance sustainable buildings. Registration is the first step toward LEED certification. Actual certification requires that the applicant project satisfy a number of requirements. Commercial buildings, as defined by standard building codes are eligible for certification. Commercial occupancies include, but are not limited to, offices, retail and service establishments, institutional buildings (e.g. libraries, schools, museums, churches, etc.), hotels, and residential buildings of four or more habitable stories.

[190] For this purpose, a brownfield site is defined by section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601), including a site described in subparagraph (D)(ii)(II)(aa) thereof (relating to a site that is contaminated by petroleum or a petroleum product excluded from the definition of 'hazardous substance' under section 101).

Application and designation process

The proposal requires the submission of an application that meets certain requirements before a project may be designated for financing with qualified green bonds. In addition to the eligibility requirements listed above, each project application must demonstrate that the net benefit of the tax-exempt financing provided will be allocated for (i) the purchase, construction, integration or other use of energy efficiency, renewable energy and sustainable design features of the project, (ii) compliance with LEED certification standards, and/or (iii) the purchase, remediation, foundation construction, and preparation of the brownfield site. The application also must demonstrate that the project is expected, based on independent analysis, to provide the equivalent of at least 1,500 full-time permanent employees (150 full-time employees in rural States) when completed and the equivalent of at least 1,000 construction employees (100 full-time employees in rural States). In addition, each project application shall contain a description of: (1) the amount of electric consumption reduced as compared to conventional construction; (2) the amount of sulfur dioxide daily emissions reduced compared to coal generation; (3) the amount of gross installed capacity of the project's solar photovoltaic capacity measured in megawatts; and (4) the amount of the project's fuel cell energy generation, measured in megawatts.

Under the proposal, each project must be nominated by a State or local government within 180 days of enactment of this Act and such State or local government must provide written assurances that the project will satisfy certain eligibility requirements. Within 60 days after the end of the application period, the Secretary, after consultation with the Administrator, will designate the qualified green building and sustainable design projects eligible for financing with qualified green bonds. At least one of the projects must be in or within a ten-mile radius of an empowerment zone (as defined under section 1391 of the Code) and at least one project must be in a rural State.[191] No more than one project is permitted in a State. A project shall not be designated for financing with qualified green bonds if such project includes a stadium or arena for professional sports exhibitions or games.

The proposal requires the Secretary, after consultation with the Administrator, to ensure that the projects designated shall, in the aggregate: (1) reduce electric consumption by more than 150 megawatts annually as compared to conventional construction; (2) reduce daily sulfur dioxide emissions by at least 10 tons compared to coal generation power; (3) expand by 75 percent the domestic solar photovoltaic market in the United States (measured in megawatts) as compared to the expansion of that market from 2001 to 2002; and (4) use at least 25 megawatts of fuel cell energy generation.

Each project must certify to the Secretary, no later than 30 days after the completion of the project, that the net benefit of the tax-exempt financing was used for the purposes described in the project application. In addition, no bond proceeds can be used to provide any facility the

[191] The term "rural State" means any State that has (1) a population of less than 4.5 million according to the 2000 census; (2) a population density of less than 150 people per square mile according to the 2000 census; and (3) increased in population by less than half the rate of the national increase between the 1990 and 2000 censuses.

principal business of which is the sale of food or alcoholic beverages for consumption on the premises.

Special rules

Under the proposal, each issuer is required to maintain, on behalf of each project, an interest bearing reserve account equal to one percent of the net proceeds of any qualified green bond issued for such project. Not later than five years after the date of issuance, the Secretary, after consultation with the Administrator, shall determine whether the financed project has substantially complied with the requirements and goals described in the project application. If the Secretary, after such consultation, certifies that the project has substantially complied with the requirements and goals, amounts in the reserve account, including all interest, shall be released to the project. If the Secretary determines that the project has not substantially complied with such requirements and goals, amounts in the reserve account, including all interest, shall be paid to the United States Treasury.

Effective Date

The proposal is effective for bonds issued after December 31, 2004.

Prior Action

Same as Senate amendment

B. Exclusion of Gain or Loss on Sale or Exchange of Certain Brownfield Sites from Unrelated Business Taxable Income

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 not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

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

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

Description of Proposal

In general

The proposal provides an exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. The exclusion is available with respect to properties acquired by the taxpayer during the period beginning January 1, 2005, and ending December 31, 2009. In addition, the proposal provides an exception from the debt-financed property rules for such properties.

In order to qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated

site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[192]

Qualifying brownfield properties

Under the proposal, the exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (as in effect on the date of enactment of the proposal). The proposal requires that the taxpayer's request for certification include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property

[192] For purposes of the proposal, a person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[193]

Qualified sale, exchange, or other disposition

Under the proposal, a sale, exchange, or other disposition of a qualifying brownfield property shall be considered as qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer's request for a remediation certification shall be made no later than the date of the transfer and shall include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[194] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially complete, and if substantially complete,[195] sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in

[193] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

[194] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

[195] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of this proposal)) was completed before the date of such request. Public notice shall include, at a minimum, publication in a major local newspaper of general circulation.

A copy of each of the requests for certification that the property was a brownfield site, and that it would no longer be a qualifying brownfield property in the hands of the transferee, shall be included in the tax return of the eligible taxpayer (and, where applicable, of the qualifying partnership) for the taxable year during which the transfer occurs.

Eligible remediation expenditures

Under the proposal, eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[196] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property, or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;[197] (3) any amount paid or

[196] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

[197] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

incurred to the extent such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the proposal.[198]

Qualifying gain or loss

The proposal generally excludes from unrelated business taxable income the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property. Income, gain, or loss from other transfers does not qualify under the proposal.[199] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. Further, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[200]

Special rules for qualifying partnerships

In general

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the proposal applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the disposition of the property.[201] A qualifying partnership is a partnership that (1) has a partnership

[198] The proposal authorizes the Secretary of the Treasury to issue guidance regarding the treatment of government-provided funds for purposes of determining eligible remediation expenditures.

[199] For example, rent income from leasing the property does not qualify under the proposal.

[200] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

[201] The proposed exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by present-law.

agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the proposal if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.[202]

Under the proposal, the Secretary shall prescribe such regulations as are necessary to prevent abuse of the requirements of the proposal, including abuse through the use of special allocations of gains or losses, or changes in ownership of partnership interests held by eligible taxpayers.

Certifications and multiple property elections

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired

[202] The proposal subjects a tax-exempt partner to tax on gain previously excluded by the partner (plus interest) if a property subsequently becomes ineligible for exclusion under the qualifying partnership's multiple-property election.

by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[203]

An acquiring taxpayer makes a multiple-property election with its timely filed tax return (including extensions) for the first taxable year for which it intends to have the election apply. A timely filed election is effective as of the first day of the taxable year of the return in which the election is included or a later day in such taxable year selected by the taxpayer. An election remains effective until the earliest of a date selected by the taxpayer, the date which is eight years after the effective date of the election, the effective date of a revocation of the election, or, in the case of a partnership, the date of the termination of the partnership. For purposes of the election, gain or loss on property acquired after December 31, 2009, is not eligible for exclusion from unrelated business taxable income, although properties acquired after such date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

A taxpayer may revoke a multiple-property election by filing a statement of revocation with a timely filed tax return (including extensions). A revocation is effective as of the first day of the taxable year of the return in which the revocation is included or a later day in such taxable year selected by the eligible taxpayer or qualifying partnership. Once a taxpayer revokes the election, the taxpayer is ineligible to make another multiple-property election with respect to any qualifying brownfield property subject to the revoked election.[204]

Debt-financed property

The proposal provides that debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the provisions of the proposal that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the proposal is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

[203] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

[204] The proposal subjects a taxpayer to tax on gain previously excluded (plus interest) in the event a site subsequently becomes ineligible for gain exclusion under the multiple-property election.

Effective Date

The proposal applies to gain or loss on the sale, exchange, or other disposition of property acquired by the taxpayer during the period beginning January 1, 2005, and ending December 31, 2009.

Prior Action

Same as Senate amendment except modified to provide that the proposal does not apply to gain or loss on property acquired after December 31, 2009.

C. Civil Rights Tax Relief

Present Law

Under present law, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness.[205] Expenses relating to recovering such damages are generally not deductible.[206]

Other damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income,[207] subject to the two-percent floor on itemized deductions.[208] Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount.[209] For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

In some cases, claimants will engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years. Some courts[210] have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney and to the overall limitation on itemized deductions. Other courts have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.[211]

---

[205] Sec. 104(a)(2).

[206] Sec. 265(a)(1).

[207] Sec. 212.

[208] Sec. 67.

[209] Sec. 68.

[210] *Kenseth v. Commissioner*, 114 T.C. 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

[211] *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Arthur Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir.

Description of Proposal

The proposal provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

Under the proposal, "unlawful discrimination" means an act that is unlawful under certain provisions of any of the following: the Civil Rights Act of 1991; the Congressional Accountability Act of 1995; the National Labor Relations Act; the Fair Labor Standards Act of 1938; the Age Discrimination in Employment Act of 1967; the Rehabilitation Act of 1973; the Employee Retirement Income Security Act of 1974; the Education Amendments of 1972; the Employee Polygraph Protection Act of 1988; the Worker Adjustment and Retraining Notification Act; the Family and Medical Leave Act of 1993; chapter 43 of Title 38 of the United States Code; the Revised Statutes; the Civil Rights Act of 1964; the Fair Housing Act; the Americans with Disabilities Act of 1990; any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law; or any provision of Federal, State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Effective Date

The proposal applies to fees and costs paid after the date of enactment with respect to any judgment or settlement occurring after such date.

Prior Action

Same as Senate amendment except for effective date.

2000). In some of these cases, such as *Cotnam*, State law has been an important consideration in determining that the claimant has no claim of right to the recovery.

D. Seven-Year Recovery Period for Certain Track Facilities

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years.

Description of Proposal

The proposal would provide a statutory 7-year recovery period for permanent motorsports racetrack complexes. For this purpose, motorsports racetrack complexes include land improvements and support facilities but do not include transportation equipment, warehouses, administrative buildings, hotels, or motels.

Effective Date

The proposal would be effective for property placed in service after date of enactment and before January 1, 2008. No inference is intended with respect to the treatment of property placed in service prior to the effective date.

Prior Action

Same as Senate amendment.

E. Distributions to Shareholders from Policyholders Surplus Account of Life Insurance Companies

Prior and Present Law

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account (sec. 815).

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

Description of Proposal

The provision suspends for a stock life insurance company's taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company (sec. 815). The provision also reverses the order in which distributions reduce the various accounts, so that distributions would be treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Effective Date

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

Prior Action

Same as the Senate amendment, except for the effective date.

F. Treat Certain Alaska Pipeline Property as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[212] . Asset class 46.0, describing assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors, are assigned a class life of 22 years and a recovery period of 15 years.

Description of Proposal

The proposal would establish a statutory seven-year recovery period and a class life of 22 years for any Alaska natural gas pipeline. The term "Alaska natural gas pipeline" is defined as any natural gas pipeline system (including the pipe, trunk lines, related equipment, and appurtenances used to carry natural gas, but not any gas processing plant) located in the State of Alaska that has a capacity of more than 500 billion Btu of natural gas per day and is placed in service after December 31, 2013. A taxpayer who places an otherwise qualifying system in service before January 1, 2014 may elect to treat the system as placed in service on January 1, 2014, thus qualifying for the seven-year recovery period.

Effective Date

The proposal would be effective for property placed in service after December 31, 2004.

Prior Action

Modification of Senate amendment.

[212] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

G. Enhanced Oil Recovery Credit for Certain Gas Processing Facilities

Present Law

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

Description of Proposal

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

Effective Date

The proposal is effective for costs paid or incurred in taxable years beginning after 2003.

Prior Action

Same as Senate amendment.

H. Method of Accounting for Naval Shipbuilders

Present Law

Generally, taxpayers must use the percentage-of-completion method to determine taxable income from long-term contracts.[213] Under sec. 10203(b)(2)(B) of the Revenue Act of 1987[214], an exception exists for certain ship construction contracts, which may be accounted for using the 40/60 percentage-of-completion/ capitalized cost method ("PCCM"). Under the 40/60 PCCM, 60% of a taxpayer's long-term contract income is exempt from the requirement to use the percentage-of-completion method while 40% remains subject to the requirement. The exempt 60% of long-term contract income must be reported by consistently using the taxpayer's exempt contract method. Permissible exempt contract methods include the percentage of completion method, the exempt-contract percentage-of-completion method, and the completed contract method.[215]

Description of Proposal

The proposal would provide that qualified naval ship contracts may be accounted for using the 40/60 PCCM during the first five taxable years of the contract. The cumulative reduction in tax resulting from the provision over the five-year period is recaptured and included in the taxpayer's tax liability in the sixth year. Qualified naval ship contracts are defined as any contract or portion thereof that is for the construction in the United States of one ship or submarine for the Federal Government if the taxpayer reasonably expects the acceptance date will occur no later than nine years after the construction commencement date.

Effective Date

The proposal would be effective for contracts with respect to which the construction commencement date occurs after date of enactment.

Prior Action

Same as Senate amendment.

---

[213] Sec. 460(a).

[214] Pub. Law No. 100-203 (1987).

[215] Treas. Reg. 1.460-4(c)(1).

I. Minimum Cost Requirement for Excess Defined Benefit Pension Plan Asset Transfers

Present Law

Defined benefit pension plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[216] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan's assets[217] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[218] In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive

---

[216] Sec. 420.

[217] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[218] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for a transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to for a transfer to be qualified, the transfer must meet the minimum cost requirement. To satisfy the minimum cost requirement, an employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years (referred to as the cost maintance period). The applicable employer cost during the cost maintenance period cannot be less than the higher of the applicable employer costs for each of the two taxable years preceding the taxable year of the transfer. The applicable employer cost is generally determined by dividing the current retiree health liabilities by the number of individuals provided coverage for applicable health benefits during the year. The Secretary is directed to prescribe regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the period from being treated as satisfying the minimum cost requirement.

Under Treasury regulations,[219] the minimum cost requirement is not satisfied if the employer significantly reduces retiree health coverage during the cost maintenance period. Under the regulations, an employer significantly reduces retiree health coverage for a year (beginning after 2001) during the cost maintenance period if either (1) the employer-initiated reduction percentage for that taxable year exceeds 10 percent, or (2) the sum of the employer-initiated reduction percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.[220] The employer-initiated reduction percentage is percentage of the number of individuals receiving coverage for applicable health benefits as of the day before the first day of the taxable year over the total number of such individuals whose coverage for applicable health benefits ended during the taxable year by reason of employer action.[221]

Description of Proposal

The proposal provides that an eligible employer does not fail the minimum cost requirement if, in lieu of any reduction of health coverage permitted by Treasury regulations, the

[219] Treas. Reg. sec. 1.420-1(a).

[220] Treas. Reg. sec. 1.420-1(b)(1).

[221] Treas. Reg. sec. 1.420-1(b)(2).

employer reduces applicable employer cost by an amount not in excess of the reduction in costs which would have occurred if the employer had made the maximum permissible reduction in retiree health coverage under such regulations. An employer is an eligible employer if, for the preceding taxable year, the qualified current retiree health liabilities of the employer were at least five percent of gross receipts.

In applying such regulations to any subsequent taxable year, any reduction in applicable employer cost under the proposal is treated as if it were an equivalent reduction in retiree health coverage.

Effective date

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

Prior Action

Same as Senate amendment.

J. Blue Ribbon Commission on Comprehensive Tax Reform

Present Law

Under present law, there is no specially-appointed commission designated to study and report on comprehensive tax reform.

Description of Proposal

The proposal establishes a commission to study and report on comprehensive tax reform. Members of the commission are to be appointed by Congressional leadership and the President.

Effective Date

Members must be appointed by June 30, 2005. The report is due no later than 18 months after all members are appointed.

Prior Action

Modification of Senate amendment.

K. Credit for Electricity Produced From Certain Sources

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt-hour for 2004. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2006, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2006, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2006. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Description of Proposal

Expansion of qualifying resources for existing facilities

Under the proposal, qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992, and modified to use closed-loop biomass to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass before January 1, 2006. The taxpayer may claim credit for electricity produced at such qualifying facilities with the credit amount equal to the otherwise allowable credit multiplied by the ratio of the thermal content of the closed-loop biomass fuel burned in the facility to the thermal content of all fuels burned in the facility.

Additional qualifying resource and facilities

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

Qualifying open-loop biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2006. Qualifying agricultural livestock waste nutrient facilities are facilities using agricultural livestock waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2006. The installed capacity of a qualified agricultural livestock waste nutrient facility is not less than 150 kilowatts.

Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1,

2006. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. A qualifying geothermal energy facility or solar energy facility may not have claimed any credit under sec. 48 of the Code.[222]

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2006. A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is not less than 150 kilowatts and less than five megawatts.

Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying landfill gas facilities and qualifying trash combustion facilities include facilities used to produce electricity placed in service after the date of enactment and before January 1, 2006.

A qualifying refined coal facility is a facility placed in service after the date of enactment and before January 1, 2009, that uses coal to produce a lower emission, higher value fuel intended to be burned to produce steam to generate electricity.

Credit period and credit rates

In general, as under present law, taxpayers may claim the credit at a rate of 1.5 cents per kilowatt-hour (indexed for inflation and currently 1.8 cents per kilowatt-hour) for 10 years of production commencing on the date the facility is placed in service. In the case of open-loop biomass facilities, (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, landfill gas facilities, and trash combustion facilities the 10-year credit period is reduced to five years commencing on the date the facility is placed in service. In general, for facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period shall begin no earlier than the date of enactment.

A qualified refined coal facility may claim credit at a rate of $4.375 per ton (indexed for inflation) of refined coal sold to a unrelated person.

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

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

Credit claimants and treatment of other subsidies

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

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

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

Effective Date

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

Prior Action

Modifies Senate amendment.

L. Certain Business Energy Credits Allowed Against the Alternative Minimum Tax

Present Law

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

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

Description of Proposal

The proposal treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to (1) for taxable years beginning after December 31, 2004, alcohol fuels credit determined under section 40; and (2) the section 45 credit for electricity produced from a facility (placed in service after the date of enactment) during the first four years of production beginning on the date the facility is placed in service.

Effective Date

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

Prior Action

Same as Senate amendment.

Conference Agreement

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

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

M. Inclusion of Primary and Secondary Medical Strategies for Children and Adults With Sickle Cell Disease as Medical Assistance under the Medicaid Program

Present Law

Medicaid programs are generally operated by the States, in part with funds received from the Federal government. Within broad Federal guidelines, States can design the scope and availability of Medicaid benefits. Medicaid law requires States to provide certain services including, for example, hospital and physician services. Federal funds are available for additional optional services if States choose to include them in their Medicaid plans. Within Federal guidelines, States may limit the amount, duration of any Medicaid service. Under present law, States may have covered some of the primary and secondary medical strategies, treatments, and services for Sickle Cell Disease, however such services are not specifically listed in the Medicaid statute as either mandatory or optional services.

The Federal government shares in States' Medicaid service costs by means of a statutory formula designed to provide a higher Federal matching rate to States with lower per capita incomes. The Federal share is referred to as the Federal Medical Assistance Percentage ("FMAP"). For some Medicaid services and activities, such as costs associated with program administration, the FMAP rate is set in statute. Because Medicaid is an individual entitlement, there is no annual ceiling on Federal expenditures; however, in order to continue receiving Federal payments, States must contribute their share of the matching funds.

Description of Proposal

The proposal amends Title XIX of the Social Security Act to add primary and secondary medical strategies, treatment and services for individuals who have Sickle Cell Disease as a new optional medical assistance category under the Medicaid program. Such strategies, treatment, and services include: (1) chronic blood transfusion (with deferoxamine chelation) to prevent stroke in individuals with Sickle Cell Disease who have been identified as being at high risk for stroke; (2) genetic counseling, testing, and treatment for individuals with Sickle Cell Disease or the Sickle Cell trait; and (3) other treatment and services to prevent individuals who have Sickle Cell Disease and who have had a stroke having another stroke. The proposal sets the FMAP rate at 50 percent for costs attributable to providing: (1) services to identify and educate likely Medicaid enrollees who have or are carriers of Sickle Cell Disease; or (2) education regarding the risks of stroke and other complications, as well as the prevention of stroke and complications for likely Medicaid enrollees with Sickle Cell Disease.

The proposal also authorizes an appropriation in the amount of $10,000,000 for each of fiscal years 2005 through 2009 for a demonstration program under which the Administrator of the Health Resources and Services Administration (through the Bureau of Primary Health Care and the Maternal Child Health Bureau) would make grants up to 40 eligible entities in each such fiscal year for the development and establishment of systemic mechanisms for the prevention and treatment of the Sickle Cell Disease. Eligible entities include Federally-qualified health centers as defined in the Medicaid statute; nonprofit hospitals or clinics, or university health centers that provide primary health care that: (1) have a collaborative agreement with a

community-based Sickle Cell Disease organization or a nonprofit entity with experience in working with individuals who have the Sickle Cell Disease; and (2) demonstrate that they have at least five years of experience in working with individuals who have the Sickle Cell Disease. Systematic mechanisms for the prevention and treatment of the Sickle Cell Disease include: (1) coordination of service delivery for individuals with the disease; (2) genetic counseling and testing; (3) bundling of technical services related to the prevention and treatment of the disease; (4) training health professionals; and (5) identifying and establishing efforts related to the expansion and coordination of education, treatment, and continuity of care programs for individuals with the disease.

In awarding such grants to eligible entities, the Administrator of Health Resources and Services Administration is to take into consideration geographic diversity and to give priority to: (1) Federally-qualified health centers that have a partnership or other arrangement with a comprehensive Sickle Cell Disease treatment center and does not receive funds from the National Institutes of Health; or (2) Federally-qualified health centers that intend to develop a partnership or other arrangement with a comprehensive Sickle Cell Disease treatment center, and that does not receive funds from the National Institutes of Health. Eligible entities that are awarded grants are required to use the funds for the following activities: (1) to facilitate and coordinate the delivery of education, treatment, and continuity of care under: (a) the entity's collaborative agreement with a community-based Sickle Cell Disease organization or a nonprofit entity that works with individuals who have Sickle Cell Disease; (b) the Sickle Cell Disease newborn screening program for the State in which the entity is located; and (c) the Maternal and Child Health program for the State in which the entity is located; (2) to train nursing and other health staff who provide care for individuals with Sickle Cell Disease; (3) to enter into a partnership with adult or pediatric hematologists in the region and other regional experts in the Sickle Cell Disease at tertiary or academic health centers and State and county health offices; and (4) to identify and secure resources for ensuring reimbursement under the Medicaid program, State children's health insurance program, and other health programs for the prevention and treatment of Sickle Cell Disease.

The proposal also requires the Administrator of Health Resources and Services Administration to enter into a contract with an entity and to serve as a National Coordinating Center for the demonstration program. The center is to: (1) collect, coordinate, monitor and distribute data, best practices, and findings regarding the activities funded under grants made to eligible entities under the demonstration program; (2) develop a model protocol for eligible entities with respect to prevention and treatment of the disease; (3) develop educational materials regarding the prevention and treatment of the disease; and (4) submit a written report to Congress. The written report to Congress should include recommendations on the effectiveness of the demonstration program direct outcome measures, such as the number and type of health care resources utilized (such as emergency room visits, hospital visits, length of stay, and physician visits for individuals with Sickle Cell Disease) and the number of individuals that were tested and subsequently received genetic counseling for the sickle cell trait.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Same as Senate amendment.

N. Suspension of Duties on Ceiling Fans

Present Law

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

Description of Proposal

The provision agreement suspends the present customs duty applicable to ceiling fans through December 31, 2006.

Effective Date

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

Prior Action

Same as House bill.

O. Suspension of Duties on Nuclear Steam Generators

Present Law

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

Description of Proposal

The proposal extends the present-law suspension of customs duty applicable to nuclear steam generators through December 31, 2008.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Same as House bill.

P. Suspension of Duties on Nuclear Reactor Vessel Heads

Present Law

According to section 5202 of the Trade Act of 2002, nuclear reactor vessel heads are classified under subheading 8401.40.00 of the Harmonized Tariff Schedule of the United States and enter the United States with a column 1 duty rate of 3.3 percent.

Description of Proposal

The proposal temporarily suspends the present customs duty applicable to nuclear reactor vessel heads and pressurizers for column 1 countries through December 31, 2008.

Effective Date

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

Prior Action

Same as House bill.

TITLE VIII – REVENUE PROVISIONS

A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation

1. Tax treatment of expatriated entities and their foreign parents

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

Under present law, a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as inversion transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Description of Proposal

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; (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.[223]

In determining whether a transaction meets the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority

[223] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions.

to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

Under the proposal, inversion transactions include certain partnership transactions. Specifically, the proposal applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" proposals apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

Effective Date

The proposal applies to taxable years ending after March 4, 2003.

Prior Action

Same as House proposal, as amended.

2. Excise tax on stock compensation of insiders in expatriated corporations

Present Law

The income taxation of a nonstatutory[224] 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.[225] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.[226]

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Description of Proposal

In general

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes an excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. The excise tax is imposed at a rate equal to the maximum rate of tax on the adjusted net capital gain of an individual (i.e., the rate of the excise tax would be 15 percent for 2005 through 2008

[224] 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.

[225] 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.

[226] Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

and 20 percent for taxable years beginning after December 31, 2008). 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.

Disqualified individuals

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[227] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[228] directors, and 10-percent-or-greater owners of private and publicly-held corporations.

Application of excise tax

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined in proposal) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction as defined in the preceding section of the proposal.

Specified stock compensation

Specified stock compensation subject to the excise tax includes any payment[229] (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether the

[227] 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.

[228] 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.

[229] Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction.

Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the proposal applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. A payment directly tied to the value of the stock is specified stock compensation. The excise tax does not apply if a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual would be paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder. By contrast, an arrangement under which a disqualified individual would be paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock.

The excise tax applies to any specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the inversion transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable 12-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, tax-sheltered annuity, simplified employee pension, or SIMPLE. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

Determination of amount subject to tax

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants or other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Secretary, that takes into account (1) the stock price at the valuation date; (2) the exercise price under the option; (3) the remaining term of the option; (4) the volatility of the underlying stock and the expected dividends on it; and (5) the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable). It is expected that the Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the 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 can rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

Other rules

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the proposal.

Effective Date

The proposal is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

Prior Action

Modification of House bill and Senate amendment.

3. Reinsurance of U.S. risks in foreign jurisdictions

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.[230] 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.[231] 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

[230] Sec. 845(a).

[231] See S. Rep. No. 97-494, 97th Cong., 2d Sess., 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The bill authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[232] 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 proposal is effective for any risk reinsured after the date of enactment of the proposal.

Prior Action

Same as House bill and same as Senate amendment except for effective date.

4. Revision of tax rules on expatriation of individuals

Present Law

In general

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g.,

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

real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[233] with a principal purpose of avoiding U.S. taxes, the individuals is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income[234] at the rates applicable to U.S. citizens for the 10-year period.

An individual who relinquishes citizenship or terminates residency is treated as having done so with a principal purpose of tax avoidance and is generally subject to the alternative tax regime if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[235] Certain categories of individuals (*e.g.*, dual residents) may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the test above). Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets.

---

[233] Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty).

[234] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[235] The income tax liability and net worth thresholds under section 877(a)(2) for 2004 are $124,000 and $622,000, respectively. *See* Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

Gift tax rules with respect to expatriates

Special gift tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the rules above). The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination.

Information reporting

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of expatriation. However, this information is only required once.

Description of Proposal

In general

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination. [236]

Objective rules for the alternative tax regime

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

[236] These provisions reflect recommendations contained in Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (*e.g.*, tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[237] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[238] and individuals with minimal prior physical presence in the United States,[239] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

Imposition of gift tax with respect to stock of certain closely held foreign corporations

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift,

---

[237] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

[238] An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

[239] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

regardless of how such stock was acquired (*e.g.*, whether issued originally to the donor, purchased, or received as a gift or bequest).

Annual return

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

Effective Date

The provision applies to individuals who relinquish citizenship or terminate long-term residency after June 3, 2004.

Prior Action

Same as House bill.

5. Reporting of taxable mergers and acquisitions

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).[240]

[240] Recently issued temporary regulations under section 6043 (relating to information reporting with respect to liquidations, recapitalizations, and changes in control) impose information reporting requirements with respect to certain taxable inversion transactions, and proposed regulations would expand these requirements more generally to taxable transactions occurring after the proposed regulations are finalized.

Description of Proposal

Under the proposal, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[241]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements are extended to failures to comply with the requirements set forth under this bill.

Effective Date

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

Prior Action

Same as House bill and Senate amendment.

[241] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Treasury Secretary.

6. Studies

Present Law

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

Under section 482, the Treasury Secretary is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's-length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration of the arm's-length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party transactions.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

Description of Proposal

The bill requires the Treasury Secretary to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provisions of this bill on inversion transactions.

Effective Date

The tax treaty study required under the provision is due no later than June 30, 2005. The transfer pricing study required under the provision is due no later than June 30, 2005. The inversions study required under the provision is due no later than December 31, 2006.

Prior Action

Same as the House bill except for effective date on inversions study, which was moved forward one year.

B. Taxpayer Shelter Proposals

1. Penalty for failing to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[242]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[243] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[244]

The second category is any transaction that is offered under conditions of confidentiality. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[245]

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.[246]

---

[242] 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.

[243] 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).

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

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

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

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[247]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[248] 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.[249]

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.[250]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure can jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[251]

Description of Proposal

In general

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty

---

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

[248] 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.

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

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

[251] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. Regulations under sections 6662 and 6664 provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The proposal does not define the terms "listed transaction"[252] or "reportable transaction," nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind (or abate) the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.[253] 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 public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction or a non-disclosed reportable avoidance transaction[254]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure

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

[253] In determining whether rescinding or abating a penalty would promote compliance with the tax laws and effective tax administration, it is intended that the IRS Commissioner take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.

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

to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

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

Prior Action

Modification of House bill and Senate amendment.

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

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[255] 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.[256]

Special rules apply with respect to tax shelters.[257] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[258] The relevant regulations provide that reasonable

---

[255] Sec. 6662.

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

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

[258] Sec. 6664(c).

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.[259]

Description of Proposal

In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as "reportable avoidance transactions").[260] 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.

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.

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 the proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return)[261], and (2) the amount of

---

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

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

[261] 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

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 proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[262] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[263] 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

---

would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

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

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

compensated directly or indirectly[264] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction--A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[265] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

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

Coordination with other penalties

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

---

[264] 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.

[265] 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).

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

Prior Action

Modification of House bill and Senate amendment.

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

Present Law

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

Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt 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 proposal is effective with respect to communications made on or after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

4. Statute of limitations for unreported listed transactions

Present Law

In general, the Code requires that taxes be assessed within three years[266] after the date a return is filed.[267] If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[268] 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.[269]

Description of Proposal

The proposal extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[270] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject extended statute of limitations.[271]

---

[266] Sec. 6501(a).

[267] 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)).

[268] Sec. 6501(e).

[269] Sec. 6501(c).

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

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

Effective Date

The proposal is effective for taxable years with respect to which the period for assessing a deficiency did not expire before date of enactment.

Prior Action

Same as House bill and Senate amendment.

5. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[272] A "tax shelter" means any investment with respect to which the tax shelter ratio[273] 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).[274]

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.[275]

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,"[276] 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

---

[272] Sec. 6111(a).

[273] 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.

[274] Sec. 6111(c).

[275] Sec. 6111(d).

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

one taxpayer.[277] Certain exceptions are provided with respect to the second category of transactions.[278]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[279]

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

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

Description of Proposal

Disclosure of reportable transactions by material advisors

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)[281] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

---

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

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

[279] 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).

[280] Sec. 6707.

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

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.[282]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, 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) or such other amount as may be prescribed by the Secretary for such advice or assistance.

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

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present-law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[283] 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.[284] All or part of the penalty may be rescinded only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only

---

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

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

[284] 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.

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

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

Prior Action

Same as Senate amendment.

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

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[285] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[286] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[287]

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.[288] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to

[285] Sec. 6112.

[286] Treas. Reg. sec. 301.6112-1.

[287] 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.

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

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.[289] 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).[290]

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.[291]

Penalty for failing to maintain investor lists

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

Description of Proposal

Investor lists

Each material advisor[292] with respect to a reportable transaction (including a listed transaction)[293] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

---

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

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

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

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

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

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[294]

Effective Date

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

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

Prior Action

Modification of House bill and Senate amendment.

7. Penalties on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[295] 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

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

[295] Sec. 6700.

penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Description of Proposal

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

Effective Date

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

Prior Action

Same as House bill.

8. Modifications to the definition of the substantial understatement

Present Law

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[296]

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.[297] The Secretary is required to prescribe annually a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers. The list is to be published in the Federal Register or the Internal Revenue Bulletin.

Description of Proposal

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

---

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

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

The proposal also modifies the requirement of the Secretary to prescribe a list of positions that do not have substantial authority, and authorizes (but does not require) the Secretary to publish such list.

Effective Date

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

Prior Action

Modification of House bill and Senate amendment.

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

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[298]

Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[299] and the keeping of lists of investors by material advisors.[300] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction, or (3) violating any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Effective Date

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

Prior Action

Same as Senate amendment.

---

[298] Sec. 7408.

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

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

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

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[301] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary 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.[302] 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.[303]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[304] This report, which was statutorily required,[305] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $10,000. 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. In addition, the

---

[301] 31 U.S.C. 5314.

[302] 31 U.S.C. 5321(a)(5).

[303] 31 U.S.C. 5322.

[304] *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.

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

proposal increases the present-law penalty for willful behavior to the greater of $100,000 or 50 percent of the amount of the transaction or account.

Effective Date

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

Prior Action

Same as Senate amendment.

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

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[306] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Description of Proposal

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

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

Effective Date

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

---

[306] 31 U.S.C. 330.

Prior Action

Same as Senate amendment.

12. Treatment of stripped interests in bond and preferred stock funds, etc.

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) whereby income that is transferred without an accompanying transfer of the underlying property is not respected. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[307]

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).[308] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[309]

---

[307] *Helvering v. Horst*, 311 U.S. 112 (1940).

[308] 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 165, 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 2003-55, 2003-34 I.R.B. 395, *modifying and superseding* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[309] 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.[310] 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.[311] 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 in 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.[312] 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.[313] 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

[310] Sec. 1286.

[311] Sec. 1286(e).

[312] Sec. 1286(a).

[313] 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.[314]

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.[315] 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.[316] 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.[317]

Description of Proposal

The proposal authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The proposal applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this proposal would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as an eligible tax-exempt bond

---

[314] 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)).

[315] Sec. 305(e)(5).

[316] Sec. 305(e)(1).

[317] Sec. 305(e)(3).

partnership described in Rev. Proc. 2003-84,[318] *modifying and superseding* Rev. Proc. 2002-68[319] *and* Rev. Proc. 2002-16.[320]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

Effective Date

The proposal is effective for purchases and dispositions occurring after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

13. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends

Present Law

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

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held

[318] 2003-48 I.R.B. 1159.

[319] 2002-43 I.R.B. 753.

[320] 2002-9 I.R.B. 572.

for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

Description of Proposal

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 31-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the proposal. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.[321]

Effective Date

The proposal is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

Prior Action

Modification of House bill and Senate amendment.

[321] It is intended that the Secretary would prescribe regulations to adapt the holding period and hedging rules of section 901(k) to property other than stock. It is anticipated such regulations would provide that credits are not disallowed merely because a taxpayer eliminates its risk of loss from interest rate or currency fluctuations. In addition, it is intended that such regulations might permit other hedging activities, such as hedging of credit risk, provided that the taxpayer does not hedge most of its risk of loss with respect to the property unless there has been a meaningful and unanticipated change in circumstances.

14. Treatment of partnership loss transfers and partnership basis adjustments

Present Law

Contributions of property

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[322] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[323] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[324] Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[325] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.[326]

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.[327] If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[328] 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

---

[322] Sec. 721.

[323] Sec. 723.

[324] Sec. 722.

[325] Sec. 704(c)(1)(A).

[326] If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for curative or remedial allocations to remedy this insufficiency. Treas. Reg. sec. 1.704-3(c) and (d).

[327] Treas. Reg. 1.704-3(a)(7).

[328] Sec. 743(a).

transferee's basis in its partnership interest.[329] 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.[330] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[331] 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).[332]

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.[333] 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.[334] 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.[335]

---

[329] Sec. 743(b).

[330] Sec. 731(a) and (b).

[331] Sec. 732(b).

[332] Sec. 732(a).

[333] Sec. 732 (a)(1) and (c).

[334] Sec. 732(d).

[335] Treas. Reg. 1.732-1(d)(4).

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.[336] 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).[337] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Description of Proposal

Contributions of property

Under the provision, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[338]

Transfers of partnership interests

The provision provides generally that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the bill, section 743(b) applies, so that an adjustment is required to the adjusted basis of the partnership assets with respect to B. As a result, B would

---

[336] Sec. 734(a).

[337] Sec. 734(b).

[338] It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

The bill provides that an electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. In lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. Under this rule, the transferee partner's distributive share of losses (determined without regard to gains) from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of such losses exceeds the loss recognized by the transferor partner. In the event of successive transfers, the transferee partner's distributive share of such losses is not allowed, except to the extent that it is established that such losses exceed the loss recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this rule). Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest. Thus, on subsequent disposition of its partnership interest, the partner's gain is reduced (or loss increased) because the basis of the partnership interest has not been reduced by such losses. The provision is applied without regard to any termination of a partnership under section 708(b)(1)(B). In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, the amount of the transferor's loss taken into account under this rule is reduced by the amount of the basis reduction.

For this purpose, an electing investment partnership means a partnership that satisfies the following requirements: (1) it makes an election under the provision that is irrevocable except with the consent of the Secretary; (2) it would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940[339] but for an exemption under paragraph (1) or (7) of section 3(c) of that Act; (3) it has never been engaged in a trade or business; (4) substantially all of its assets are held for investment; (5) at least 95 percent of the assets contributed to it consist of money; (6) no assets contributed to it had an adjusted basis in excess of fair market value at the time of contribution; (7) all partnership interests are issued by the partnership pursuant to a private offering and prior to the date that is 24 months after the date of the first capital contribution to the partnership; (8) the partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and (9) the partnership agreement provides for a term that is not in excess of 15 years.

The provision requires an electing investment partnership to furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule.

The provision provides that a securitization partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. Partnership basis adjustments remain elective in the case of a transfer of an interest in a securitization partnership.

---

[339] Section 3(a)(1)(A) of the Act provides, “when used in this title, 'investment company' means any issuer which is or hold itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”

Distributions of partnership property

The provision provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million, and that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C's hands is $5 million. Under present law, C would recognize a loss of $4 million if the LMN stock were sold for $1 million.

Under the provision, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than $250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by $2 million (the amount by which the basis of LMN stock was increased), leaving a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million.

Effective Date

The provision applies to contributions, distributions and transfers (as the case may be) after the date of enactment.

In the case of an electing investment partnership in existence on June 4, 2004, the requirement that the partnership agreement have substantive restrictions on redemptions does not apply, and the requirement that the partnership agreement provide for a term not exceeding 15 years is modified to permit a term not exceeding 20 years.

Prior Action

Same as the House bill, with modifications.

15. No reduction of basis under section 734 in stock held by partnership in corporate partner

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.[340] Similarly, a partner and the partnership generally do not recognize

[340] Sec. 721(a).

gain or loss on the distribution of partnership property.[341] 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).[342] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

Election to adjust basis of partnership property

When a partnership distributes partnership property, the basis of partnership property generally is not adjusted to reflect the effects of the distribution or transfer. However, the partnership is permitted to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[343] 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.[344] 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

[341] Sec. 731(a) and (b).

[342] Sec. 732(b).

[343] Sec. 754.

[344] Sec. 755(a).

depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[345]

Description of Proposal

The provision provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the provision, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective Date

The provision applies to distributions after the date of enactment.

Prior Action

Same as House bill.

16. Repeal of special rules for FASITs, etc.

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.[346] A FASIT generally is not taxable. Instead, the FASIT's taxable income or net loss flows through to the owner of the FASIT. The ownership interest of a FASIT generally is required to be held entirely 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.

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;[347] (2) have assets substantially all of which

---

[345] Sec. 755(b).

[346] Sections 860H-860L.

[347] 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

(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 generally must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the 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. Instruments that do not satisfy certain of these general requirements nevertheless may be treated as regular interests if they are held by a domestic taxable C corporation that is not a RIC, real estate investment trust ("REIT"), FASIT, 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

---

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.

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 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.[348] 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 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.

Description of Proposal

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the proposal also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real

[348] *See* sections 860A-860G.

estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the proposal 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 proposal makes three modifications to the present-law definition of a "qualified mortgage." First, the proposal 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 proposal 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 proposal 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 proposal modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

Effective Date

Except as provided by the transition period for existing FASITs, the proposal is effective on January 1, 2005.

Prior Action

Same as House bill, and same as Senate amendment except for effective date.

17. Limitation on transfer and importation of built-in losses

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[349] 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.[350]

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.[351]

Description of Proposal

Importation of built-in losses

The proposal provides that if a net built-in loss is imported into the U.S in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the proposal, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceeds the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U.S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if each partner had transferred such partner's proportionate share of the property of such partnership.

---

[349] Sec. 351.

[350] Sec. 358.

[351] Secs. 334(b) and 362(a) and (b).

Limitation on transfer of built-in-losses in section 351 transactions

The proposal 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 generally is limited to the aggregate fair market value of the transferred property. Under the proposal, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. The proposal permits the transferor and transferee to elect to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred. Such election shall be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, shall be irrevocable.

Effective Date

The proposal applies to transactions after the date of enactment.

Prior Action

Modification of Senate amendment.

18. Clarification of banking business for purposes of determining investment of earnings in U.S. property

Present Law

In general, the subpart F rules[352] 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.[353]

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.[354] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the

[352] Secs. 951-964.

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

[354] Sec. 956(a).

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.[355] 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.[356]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[357]

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.[358]

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*[359]

---

[355] Secs. 956 and 959.

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

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

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

[359] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

Description of Proposal

The proposal provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with: (1) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c), without regard to paragraphs (C) and (G) of paragraph (2) of such section); or (2) any other corporation with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law.

Effective Date

This proposal is effective on the date of enactment.

Prior Action

Modification of House bill and Senate amendment.

19. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[360] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from

[360] Sec. 163(a).

an undisclosed listed transaction or from an undisclosed reportable avoidance transaction (other than a listed transaction).[361]

Effective Date

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

Prior Action

Same as House bill.

20. Clarification of rules for payment of estimated tax for certain deemed asset sales

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

Description of Proposal

The proposal 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).

---

[361] The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions.

Under the proposal, 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 proposal is effective for qualified stock purchase transactions that occur after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

21. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[362] 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.

Description of Proposal

The proposal provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

---

[362] Sec. 121.

Effective Date

The proposal is effective for sales or exchanges of principal residences after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

22. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (secs. 951-964), the passive foreign investment company rules (secs. 1291-1298), and the foreign personal holding company rules (secs. 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[363] 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).[364] 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

[363] Sec. 163(e)(1).

[364] Sec. 163(e)(3).

allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[365]

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.[366] 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).[367] 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.[368]

Description of Proposal

The proposal provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules.[369] Deductions that have accrued but are not allowable under the proposal are allowed when the amounts are paid.

For purposes of determining the amount of the deduction allowable, the extent that an amount attributable to OID or an item is includible in the income of a U.S. person is determined without regard to (1) properly allocable deductions of the related foreign corporation, and (2) qualified deficits of the related foreign corporation under section 952(c)(1)(B). Properly allocable deductions of the related foreign corporation are those expenses, losses, and other deductible amounts of the related foreign corporation that are properly allocable, under the principles of section 954(b)(5), to the relevant income item of the related foreign corporation.

---

[365] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue have in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[366] Sec. 267(a)(2).

[367] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[368] Treas. Reg. sec. 1.267(a)-3(c)(4).

[369] Section 413 of the proposal repeals the foreign personal holding company regime, effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The proposal grants the Secretary regulatory authority to exempt transactions from these rules, including any transactions entered into by the payor in the ordinary course of a trade or business in which the payor is predominantly engaged, and (in the case of items other than OID) in which the payment of the accrued amounts occurs shortly after its accrual.

Effective Date

The proposal is effective for payments accrued on or after date of enactment.

Prior Action

Same as House bill and Senate amendment.

23. Deposits made to suspend the running of interest on potential underpayments

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the

assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

Description of Proposal

In general

The provision allows a taxpayer to deposit cash with the IRS that may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is deposited for the period that the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Withdrawal of amounts

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of

the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer (1) has a reasonable basis for the treatment used on its return and (2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

Effective Date

Deposits made after date of enactment.

Prior Action

Same as House bill and Senate amendment.

24. Authorize IRS to enter into installment agreements that provide for partial payment

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

Description of Proposal

The provision clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The provision also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Effective Date

Installment agreements entered into on or after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

25. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[370]

Section 1502 states:

[370] Sec. 1501.

> 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.[371]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[372]

In the recent case of *Rite Aid Corp. v. United States*,[373] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[374] The particular

---

[371] Sec. 1502.

[372] 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.

[373] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[374] 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

provision, known as the "duplicated loss" provision,[375] 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.[376]

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.[377]

---

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."

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

[376] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[377] 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).

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."[378] 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." [379]

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

---

[378] 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).

[379] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

> 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.[380]

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.[381]

Description of Proposal

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined 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 proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a

---

[380] *Rite Aid*, 255 F.3d at 1360.

[381] *See* Temp. Reg. Sec. 1.1502-20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See*, *e.g.*,Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); T.D. 9048, 68 F.R. 12287 (March 14, 2003); and T.D. 9118, REG-153172-03 (March 17, 2004).

deconsolidating disposition of stock of a consolidated subsidiary[382] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[383]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[384]

Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is intended that the results following from this proposal are not the same as the results under present law.

Prior Action

Same as House bill and Senate amendment.

26. Expanded disallowance of deduction for interest on convertible debt

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

---

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

[383] 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).

[384] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)); and T.D. 9118, REG-153172-03 (March 17, 2004). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

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.[385] 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.[386] 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.[387]

Description of Proposal

The proposal 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 proposal, 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 proposal. The proposal directs the Secretary to issue regulations that provide rules for determining the manner in which the basis of equity held by the issuer (or related party) is increased by the amount of interest deductions that is disallowed under the proposal.

The proposal does not apply to debt that is issued by an active dealer in securities (or a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

---

[385] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

[386] Sec. 163(l)(3)(B).

[387] Sec. 163(l)(3)(C).

Effective Date

This proposal applies to debt instruments that are issued after October 4, 2004.

Prior Action

Same as Senate amendment except for effective date.

27. Reform of tax treatment of certain leasing arrangements and limitation on deductions allocable to property used by governments or other tax-exempt entities

Present Law

Overview of depreciation

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods based on such property's class life. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years and are significantly shorter than the property's class life, which is intended to approximate the economic useful life of the property. In addition, the depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Characterization of leases for tax purposes

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[388]

Recovery period for tax-exempt use property

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease

[388] *Frank Lyon Co. v. United States,* 435 U.S. 561, 583-84 (1978).

term.[389] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term lease) to a tax-exempt entity.[390] For this purpose, the term "tax-exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[391]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[392] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[393]

Also, tax-exempt use property generally does not include qualified technological equipment that meets the exception for leases of high technology equipment to tax-exempt entities with lease terms of five years or less.[394] The recovery period for qualified technological equipment that is treated as tax-exempt use property, but is not subject to the high technology equipment exception, is five years.[395]

---

[389] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

[390] Sec. 168(h)(1).

[391] Sec. 168(h)(2).

[392] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[393] Sec. 168(h)(1)(C).

[394] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[395] Sec. 168(g)(3)(C).

The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[396] In addition, tax-exempt use property does not include computer software because it is intangible property.

Description of Proposal

Overview

The proposal modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

Modify the recovery period of certain property leased to a tax-exempt entity

The proposal modifies the recovery period for qualified technological equipment, computer software, and section 197 intangibles leased to a tax-exempt entity[397] to be the longer of the property's assigned class life or 125 percent of the lease term.[398] The proposal does not apply to short-term leases, as defined under present law with a modification described below for short-term leases of qualified technological equipment.

Modify definition of lease term

In determining the length of the lease term for purposes of the 125-percent calculation, the proposal provides that the lease term includes all service contracts (whether or not treated as a lease under section 7701(e)) and other similar arrangements that follow a lease of property to a tax-exempt entity and that are part of the same transaction (or series of transactions) as the lease. Under the proposal, service contracts and other similar arrangements include arrangements by which services are provided using the property in exchange for fees that provide a source of repayment of the capital investment in the property.[399] This requirement applies to all leases of property to a tax-exempt entity.

---

[396] Sec. 168(i)(2).

[397] The proposal expands the present-law definition of tax-exempt entity to include certain Indian tribal governments in addition to Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

[398] In the case of computer software and intangible assets, this rule is applied substituting useful life and amortization period, respectively, for class life.

[399] For purposes of the proposal, a service contract does not include an arrangement for the provision of services if the leased property or substantially similar property is not utilized to provide such services. For example, if at the conclusion of a lease term, a tax-exempt lessee purchases property from the taxpayer and enters into an agreement pursuant to which the

Expand short-term lease exception for qualified technological equipment

For purposes of determining whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present-law 5-year short-term lease exception for leases of qualified technological equipment, the proposal provides that the term of the lease does not include an option or options of the lessee to renew or extend the lease, provided the rents under the renewal or extension are based upon fair market value determined at the time of the renewal or extension. The aggregate period of such renewals or extensions not included in the lease term under this provision may not exceed 24 months. In addition, this provision does not apply to any period following the failure of a tax-exempt lessee to exercise a purchase option if the result of such failure is that the lease renews automatically at fair market value rents.

Limit deductions for leases of property to tax-exempt parties

The proposal also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This provision does not apply to certain transactions involving property with respect to which the low-income housing credit or the rehabilitation credit is allowable.

This provision applies to deductions or losses related to a lease to a tax-exempt entity and the leased property.[400] Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year subject to the same limitations. Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all disposition gain or loss is recognized),[401] a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations of this provision if the lease satisfies all of the following requirements:[402]

---

taxpayer maintains the property, the maintenance agreement will not be included in the lease term for purposes of the 125-percent computation.

[400] Deductions related to a lease of tax-exempt use property include any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.

[401] *See* Sec. 469(g).

[402] Even if a transaction satisfies each of the following requirements, the taxpayer will be treated as the owner of the leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property under the present-law tax rules, including the benefits and burdens of ownership.

(1) Tax-exempt lessee does not monetize its lease obligations

In general, the tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis[403] in the leased property at the time the lease is entered into.[404] Specifically, a lease does not satisfy this requirement if the tax-exempt lessee monetizes such excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or options under the lease. This determination shall be made at all times during the lease term and shall include the amount of any interest or other income or gain earned on any amount set aside or subject to an arrangement described in this provision. For purposes of determining whether amounts have been set aside or are expected to be set aside, amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that such amounts are set aside or expected to be set aside.[405]

The Secretary may provide by regulations that this requirement is satisfied, even if a tax-exempt lessee monetizes its lease obligations or options in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property, in cases in which the creditworthiness of the tax-exempt lessee would not otherwise satisfy the taxpayer's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's adjusted basis in the property. In addition, if the lease provides the tax-exempt lessee an option to purchase the property for a fixed purchase price (or for other than the fair market value of the property determined at the time of exercise of the option), such credit support at the time that such option may be exercised would not be permitted to exceed 50 percent of the purchase option price.

Certain circular lease transactions fail this requirement without regard to the amount by which the tax-exempt lessee monetizes its lease obligations or options. Thus, a lease does not satisfy this requirement if the tax-exempt lessee enters into an arrangement to monetize in any

---

[403] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[404] Arrangements to monetize lease obligations include defeasance arrangements, loans by the tax-exempt entity (or an affiliate) to the taxpayer (or an affiliate) or any lender, deposit agreements, letters of credit collateralized with cash or cash equivalents, payment undertaking agreements, prepaid rent (within the meaning of the regulations under section 467), sinking fund arrangements, guaranteed investment contracts, financial guaranty insurance, or any similar arrangements.

[405] It is anticipated that the customary and budgeted funding by tax-exempt entities of unrestricted accounts or funds for general working capital needs or for the purpose of exercising a purchase option under a lease will not be considered arrangements, set-asides, or expected set-asides under this requirement.

amount its lease obligations or options if such arrangement involves (1) a loan (other than an amount treated as a loan under section 467 with respect to a section 467 rental agreement) from the tax-exempt lessee to the taxpayer or a lender, (2) a deposit that is received, a letter of credit that is issued, or a payment undertaking agreement that is entered into by a lender otherwise involved in the transaction, or (3) in the case of a transaction that involves a lender, any credit support made available to the taxpayer in which any such lender does not have a claim that is senior to the taxpayer.

(2) Taxpayer makes and maintains a substantial equity investment in the leased property

The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis[406] in the leased property at that time,[407] (2) the taxpayer maintains such equity investment throughout the lease term (unless the lease term is 5 years or less), and (3) at all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis (unless the lease term is 5 years or less).[408] For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property.

(3) Tax-exempt lessee does not bear more than a minimal risk of loss

The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease.[409] For this purpose, a tax-exempt lessee

---

[406] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[407] The taxpayer's at-risk equity investment shall include only consideration paid, and personal liability incurred, by the taxpayer to acquire the property. *Cf.* Rev. Proc. 2001-28, 2001-2 C.B. 1156.

[408] *Cf.* Rev. Proc. 2001-28, sec. 4.01(2), 2001-1 C.B. 1156. The fair market value of the property must be determined without regard to inflation or deflation during the lease term and after subtracting the cost of removing the property.

[409] Examples of arrangements by which a tax-exempt lessee might assume or retain a risk of loss include put options, residual value guarantees, residual value insurance, and service contracts. However, leases do not fail to satisfy this requirement solely by reason of lease provisions that require the tax-exempt lessee to pay a contractually stipulated loss value to the

assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination.[410] In addition, the Secretary may provide by regulations that this requirement is not satisfied where the tax-exempt lessee otherwise retains or assumes more than a minimal risk of loss. Such regulations shall be prospective only.

This requirement does not apply to leases with lease terms of 5 years or less.

(4) Tax-exempt lessee does not have option to purchase certain property (other than at fair market value)

Generally, the tax-exempt lessee may not have an option to purchase the leased property for any purchase price other than the fair market value of the property (determined at the time of exercise).

This requirement does not apply to property with a class life of seven years or less, or to any fixed-wing aircraft or vessels.

Coordination with like-kind exchange and involuntary conversion rules

Under this provision, neither the like-kind exchange rules (sec. 1031) nor the involuntary conversion rules (sec. 1033) apply if either (1) the exchanged or converted property is tax-exempt use property subject to a lease that was entered into prior to the effective date of this provision and the lease would not have satisfied the requirements of this provision had such requirements been in effect when the lease was entered into, or (2) the replacement property is tax-exempt use property subject to a lease that does not meet the requirements of this provision.

Other rules

This provision continues to apply throughout the lease term to property that initially was tax-exempt use property, even if the property ceases to be tax-exempt use property during the

---

taxpayer in the event of an early termination due to a casualty loss, a material default by the tax-exempt lessee (excluding the failure by the tax-exempt lessee to enter into an arrangement described above), or other similar extraordinary events that are not reasonably expected to occur at lease inception.

[410] For purposes of this requirement, residual value protection provided to the taxpayer by a manufacturer or dealer of the leased property is not treated as borne by the tax-exempt lessee if the manufacturer or dealer provides such residual value protection to customers in the ordinary course of its business.

lease term.[411] In addition, this provision is applied before the application of the passive activity loss rules under section 469.

This provision does not alter the treatment of any Qualified Motor Vehicle Operating Agreement within the meaning of section 7701(h). In the case of any such agreement, the second and third requirements provided by this provision (relating to taxpayer equity investment and tax-exempt lessee risk of loss, respectively) shall be applied without regard to any terminal rental adjustment clause.

Effective Date

The proposal generally is effective for leases entered into after March 12, 2004.[412] However, the proposal does not apply to property located in the United States that is subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2005, and (3) includes a description and the fair market value of such property.

The provisions relating to coordination with the like-kind exchange and involuntary conversion rules are effective with respect to property that is exchanged or converted after the date of enactment.

The provisions relating to section 197 intangibles and the provisions relating to Indian tribal governments are effective for leases entered into after October 3, 2004.

No inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date of this proposal. In addition, it is intended that this proposal shall not be construed as altering or supplanting the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property, including the benefits and burdens of ownership. This proposal also is not intended to affect the scope of any other present-law tax rules or doctrines applicable to purported leasing transactions.

---

[411] Conversely, however, a lease of property that is not tax-exempt use property does not become subject to this provision solely by reason of requisition or seizure by the Federal government in national emergency circumstances.

[412] If a lease entered into on or before March 12, 2004, is transferred in a transaction that does not materially alter the terms of such lease, this proposal shall not apply to the lease as a result of such transfer.

C. Reduction of Fuel Tax Evasion

1. Exemption from certain excise taxes for mobile machinery vehicles

Present Law

Under present law, the definition of a "highway vehicle" affects the application of the retail tax on heavy vehicles, the heavy vehicle use tax, the tax on tires, and fuel taxes.[413] Section 4051 of the Code provides for a 12-percent retail sales tax on tractors, heavy trucks with a gross vehicle weight ("GVW") over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 provides for a tax on highway vehicle tires that weigh more than 40 pounds, with higher rates of tax for heavier tires. Section 4481 provides for an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the Leaking Underground Storage Tank ("LUST") Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the LUST Trust Fund.

The Code does not define a "highway vehicle." For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for non-transportation functions (the "mobile machinery exception"); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the "off-highway transportation vehicle" exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance of non-transportation functions off the public highways.[414]

The mobile machinery exception applies if three tests are met: (1) the vehicle consists of a chassis to which jobsite machinery (unrelated to transportation) has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery; and (3) by reason of such special design, the chassis could not, without substantial structural modification, be used to transport a load other than the particular machinery. An example of a mobile machinery vehicle is a crane mounted on a truck chassis that meets the forgoing factors.

---

[413] Secs. 4051, 4071, 4481, 4041 and 4081.

[414] See Treas. Reg. sec. 48.4061-1(d)).

On June 6, 2002, the Treasury Department put forth proposed regulations that would eliminate the mobile machinery exception.[415] The other exceptions from the definition of highway vehicle would continue to apply with some modifications. Under the proposed regulations, the chassis of a mobile machinery vehicle would be subject to the retail sales tax on heavy vehicles unless the vehicle qualified under the off-highway transportation vehicle exception. Also, under the proposed regulations, mobile machinery vehicles may be subject to the heavy vehicle use tax. In addition, the tax credits, refunds, and exemptions from tax may not be available for the fuel used in these vehicles.

Description of Proposal

The proposal codifies the present-law mobile machinery exemption for purposes of three taxes: the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. Thus, if a vehicle can satisfy the three-part test, it will not be treated as a highway vehicle and will be exempt from these taxes.

For purposes of the fuel excise tax, the three-part design test is codified and a use test is added by the proposal. Specifically, in addition to the three-part design test, the vehicle must not have traveled more than 7,500 miles over the public highways during the owner's taxable year. Refunds of fuel taxes are permitted on an annual basis only. For purposes of this rule, a person's taxable year is his taxable year for income tax purposes. Vehicles owned by an organization described in section 501(c), exempt from tax under section 501(a), need only satisfy the three-part design test to recover taxes paid with respect to such vehicles.

Effective Date

The proposal generally is effective after the date of enactment. As to the fuel taxes, the proposal is effective for taxable years beginning after the date of enactment.

Prior Action

Similar to the House bill except contains the special rule for 501(c) organizations from the Senate amendment.

2. Modify definition of off-highway vehicle

Present Law

Under present law, the definition of a "highway vehicle" affects the application of the retail tax on heavy vehicles, the heavy vehicle use tax, the tax on tires, and fuel taxes.[416] Section 4051 of the Code imposes a 12-percent retail sales tax on tractors and heavy trucks with a gross vehicle weight ("GVW") over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 imposes a tax on highway vehicle tires that weigh more than 40 pounds, with

[415] Prop. Treas. Reg. sec. 48.4051-1(a), 67 Fed. Reg. 38913, 38914-38915 (2002).

[416] Secs. 4051, 4071, 4481, 4041, and 4081.

higher rates of tax for heavier tires. Section 4481 imposes an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cents per gallon is paid into the Leaking Underground Storage Tank ("LUST") Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cents per gallon is paid into the LUST Trust Fund.

The Code does not define a "highway vehicle." For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for nontransportation functions (the "mobile machinery exception"); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the "off-highway transportation vehicle" exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance of non-transportation functions off the public highways.[417]

On June 6, 2002, the Treasury Department put forth proposed regulations that would modify the off-highway transportation vehicle exception.[418] Under the proposed regulations, a vehicle is not treated as a highway vehicle if it is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design its capability to transport a load over the public highway is substantially limited or impaired. A vehicle's design is determined solely on the basis of its physical characteristics. In determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether it is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether it can transport a load at a sustained speed of at least 25 miles per hour. Under the proposed regulation, it is not material that a vehicle can transport a greater load off the public highway than it is permitted to transport over the public highway.

The proposed regulation provides an exception to the definition of a highway vehicle for nontransportation trailers and semitrailers.[419] Under the proposed regulation, a trailer or semitrailer is not treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an offhighway function at an offhighway site.

---

[417] *See* Treas. Reg. sec. 48.4061-1(d)).

[418] Prop. Treas. Reg. sec. 48.4051-1(a)(2)(i).

[419] Prop. Treas. Reg. sec. 48.4051-1(a)(2)(ii).

For example, a trailer that is capable only of functioning as an office for an offhighway construction operation is not a highway vehicle.

Description of Proposal

The proposal adopts the definition of an offhighway transportation vehicle and a nontransportation trailer and semitrailer described in Proposed Treasury Regulation section 48.4051-1(a)(2).

For example, as provided in the proposed regulations,[420] Vehicle C consists of a truck chassis on which an oversize body designed to transport and apply liquid agricultural chemicals on farms has been installed. It is capable of transporting a load over the public highway. It is 132 inches in width, which is considerably in excess of standard highway vehicle width. For travel on uneven and soft terrain, it is equipped with oversize wheels with high-flotation tires, and nonstandard axles, brakes, and transmission. It has a special fuel and carburetor air filtration system that enable it to perform efficiently in an environment of dirt and dust. It is not able to maintain a speed of 25 miles per hour for more than one mile while fully loaded. Because Vehicle C is a self-propelled vehicle capable of transporting a load over the public highway, it would meet the general definition of a highway vehicle. However, its considerable physical characteristics for transporting its load other than over the public highway, when compared with its physical characteristics for transporting the load over the public highway, establish that it is specially designed for the primary function of transporting its load other than over the public highway. Further, the physical characteristics for transporting its load other than over the public highway substantially limit its capability to transport a load over the public highway. Therefore, Vehicle C is an offhighway vehicle and is not treated as a highway vehicle.

Effective Date

The proposal generally is effective after the date of enactment. As to the fuel taxes, the proposal is effective for taxable years beginning after the date of enactment.

Prior Action

No prior action.

[420] Prop. Treas. Reg. sec. 48.4051-1(c), *Example (3)*.

3. Taxation of Aviation-Grade Kerosene

Present Law

In general

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.[421] Unlike other fuels that generally are taxed upon removal from a terminal rack,[422] aviation fuel is taxed upon sale of the fuel by a producer or importer.[423] Sales by a registered producer to another registered producer are exempt from tax, with the result that, as a practical matter, aviation fuel is not taxed until the fuel is used at the airport (or sold to an unregistered person). Use of untaxed aviation fuel by a producer is treated as a taxable sale.[424] The producer or importer is liable for the tax. The rate of tax on aviation fuel is 21.9 cents per gallon.[425]

The tax on aviation fuel is reported by filing Form 720 - Quarterly Federal Excise Tax Return. Generally, semi-monthly deposits are required using Form 8109B - Federal Tax Deposit Coupon or by depositing the tax by electronic funds transfer.

Partial exemptions

In general, aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.[426] Commercial aviation means any use of an aircraft in a business of

---

[421] Sec. 4093(a).

[422] A rack is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel. Treas. Reg. sec. 48.4081-1(b).

[423] Sec. 4091(a)(1).

[424] Sec. 4091(a)(2).

[425] Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) and 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

[426] Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), and 4221(d)(3).

transporting persons or property for compensation or hire by air (unless the use is allocable to any transportation exempt from certain excise taxes).[427]

In order to qualify for the 4.4 cents per gallon rate, the person engaged in commercial aviation must be registered with the Secretary[428] and provide the seller with a written exemption certificate stating the airline's name, address, taxpayer identification number, registration number, and intended use of the fuel. A person that is registered as a buyer of aviation fuel for use in commercial aviation generally is assigned a registration number with a "Y" suffix (a "Y" registrant), which entitles the registrant to purchase aviation fuel at the 4.4 cents per gallon rate.

Large commercial airlines that also are producers of aviation fuel qualify for registration numbers with an "H" suffix. As producers of aviation fuel, "H" registrants may buy aviation fuel tax free pursuant to a full exemption that applies to sales of aviation fuel by a registered producer to a registered producer. If the "H" registrant ultimately uses such untaxed fuel in domestic commercial aviation, the H registrant is liable for the aviation fuel tax at the 4.4 cents per gallon rate.

Exemptions

Aviation fuel sold by a producer or importer for use by the buyer in a nontaxable use is exempt from the excise tax on sales of aviation fuel.[429] To qualify for the exemption, the buyer must provide the seller with a written exemption certificate stating the buyer's name, address, taxpayer identification number, registration number (if applicable), and intended use of the fuel.

Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions;[430] (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing

[427] Secs. 4092(b) and 4041(c)(2).

[428] Notice 88-132, sec. III(D). See also, Form 637 - Application for Registration (For Certain Excise Tax Activities). A bond may be required as a condition of registration.

[429] Sec. 4092(a).

[430] "Trade" includes the transportation of persons or property for hire. Treas. Reg. sec. 48.4221-4(b)(8).

aircraft for purposes of providing transportation with respect to which certain requirements are met.[431]

A producer that is registered with the Secretary may sell aviation fuel tax-free to another registered producer.[432] Producers include refiners, blenders, wholesale distributors of aviation fuel, dealers selling aviation fuel exclusively to producers of aviation fuel, the actual producer of the aviation fuel, and with respect to fuel purchased at a reduced rate, the purchaser of such fuel.

Refunds and credits

A claim for refund of taxed aviation fuel held by a registered aviation fuel producer is allowed[433] (without interest) if: (1) the aviation fuel tax was paid by an importer or producer (the "first producer") and the tax has not otherwise been credited or refunded; (2) the aviation fuel was acquired by a registered aviation fuel producer (the "second producer") after the tax was paid; (3) the second producer files a timely refund claim with the proper information; and (4) the first producer and any other person that owns the fuel after its sale by the first producer and before its purchase by the second producer have met certain reporting requirements.[434] Refund claims should contain the volume and type of aviation fuel, the date on which the second producer acquired the fuel, the amount of tax that the first producer paid, a statement by the claimant that the amount of tax was not collected nor included in the sales price of the fuel by the claimant when the fuel was sold to a subsequent purchaser, the name, address, and employer identification number of the first producer, and a copy of any required statement of a subsequent seller (subsequent to the first producer but prior to the second producer) that the second producer received. A claim for refund is filed on Form 8849, Claim for Refund of Excise Taxes, and may not be combined with any other refunds.[435]

A payment is allowable to the ultimate purchaser of taxed aviation fuel if the aviation fuel is used in a nontaxable use.[436] A claim for payment may be made on Form 8849 or on Form 720, Schedule C. A claim made on Form 720, Schedule C, may be netted against the claimant's excise tax liability.[437] Claims for payment not so taken may be allowable as income tax credits[438] on Form 4136, Credit for Federal Tax Paid on Fuels.

---

[431] Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 4092.

[432] Sec. 4092(c).

[433] Sec. 4091(d).

[434] Treas. Reg. sec. 48.4091-3(b).

[435] Treas. Reg. sec. 48.4091-3(d)(1).

[436] Sec. 6427(l)(1).

[437] Treas. Reg. sec. 40.6302(c)-1(a)(3).

[438] Sec. 34.

Description of Proposal

The proposal changes the incidence of taxation of aviation fuel from the sale of aviation fuel to the removal of aviation fuel from a refinery or terminal, or the entry into the United States of aviation fuel. Sales of not previously taxed aviation fuel to an unregistered person also are subject to tax.

Under the proposal, the full rate of tax -- 21.9 cents per gallon -- is imposed upon removal of aviation fuel from a refinery or terminal (or entry into the United States). Aviation fuel may be removed at a reduced rate -- either 4.4 or zero cents per gallon -- only if the aviation fuel is: (1) removed directly into the wing of an aircraft (i) that is registered with the Secretary as a buyer of aviation fuel for use in commercial aviation (e.g., a "Y" registrant under current law), (ii) that is a foreign airline entitled to the present law exemption for aviation fuel used in foreign trade, or (iii) for a tax-exempt use; or (2) removed or entered as part of an exempt bulk transfer.[439] An exempt bulk transfer is a removal or entry of aviation fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the aviation fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.

Under a special rule, the proposal treats certain refueler trucks, tankers, and tank wagons as a terminal if certain requirements are met. For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation fuel from a terminal: (1) that is located within a secured area of an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. It is intended that a terminal is located within a secured area of an airport if the terminal is located in a secure facility on airport grounds. For example, if an access road runs between a terminal and an airport's runways, and the terminal, like the runways, is physically located on airport grounds and is part of a secure facility, it is intended that under the proposal the terminal is located within the airport. The Secretary is required to publish by December 15, 2004, and maintain a list of airports which include a secured area in which a terminal is located. It is intended that an exigent circumstance under which loading a vehicle registered for highway use with fuel would not disqualify a terminal under the special rule, includes, for example, the unloading of fuel from bulk storage tanks into highway vehicles in order to repair the storage tanks.

In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) be loaded with aviation fuel for delivery into aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be registered for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily

[439] See sec. 4081(a)(1)(B).

accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.[440]

The proposal does not change the applicable rates of tax under present law, 21.9 cents per gallon for use in noncommercial aviation, 4.4 cents per gallon for use in commercial aviation, and zero cents per gallon for use by domestic airlines in an international flight, by foreign airlines, or other nontaxable use. The proposal imposes liability for the tax on aviation fuel removed from a refinery or terminal directly into the wing of an aircraft for use in commercial aviation on the person receiving the fuel, in which case, such person self-assesses the tax on a return. The proposal does not change present-law nontaxable uses of aviation fuel, or change the persons or the qualifications of persons who are entitled to purchase fuel at a reduced rate, except that a producer is not permitted to purchase aviation fuel at a reduced rate by reason of such persons' status as a producer.

Under the proposal, a refund is allowable to the ultimate vendor of aviation fuel if such ultimate vendor purchases fuel tax paid and subsequently sells the fuel to a person qualified to purchase at a reduced rate and who waives the right to a refund. In such a case, the proposal permits an ultimate vendor to net refund claims against any excise tax liability of the ultimate vendor, in a manner similar to the present law treatment of ultimate purchaser payment claims.

As under present law, if previously taxed aviation fuel is used for a nontaxable use, the ultimate purchaser may claim a refund for the tax previously paid. If previously taxed aviation fuel is used for a taxable non aircraft use, the fuel is subject to the tax imposed on kerosene (24.4 cents per gallon) and a refund of the previously paid aviation fuel tax is allowed. Claims by the ultimate vendor or the purchaser that are not taken as refund claims may be allowable as income tax credits.

For example, for an airport that is not served by a pipeline, aviation fuel generally is removed from a terminal and transported to an airport storage facility for eventual use at the airport. In such a case, the aviation fuel will be taxed at 21.9 cents per gallon upon removal from the terminal. At the airport, if the fuel is purchased from a vendor by a person registered with the Secretary to use fuel in commercial aviation, the purchaser may buy the fuel at a reduced rate (generally, 4.4 cents per gallon for domestic flights and zero cents per gallon for international flights) and waive the right to a refund. The ultimate vendor generally may claim a refund for the difference between 21.9 cents per gallon of tax paid upon removal and the rate of tax paid to the vendor by the purchaser. To obtain a zero rate upon purchase, a registered domestic airline must certify to the vendor at the time of purchase that the fuel is for use in an international flight; otherwise, the airline must pay the 4.4 cents per gallon rate and file a claim for refund to the Secretary if the fuel is used for international aviation. If a zero rate is paid and the fuel subsequently is used in domestic and not international travel, the domestic airline is liable for tax at 4.4 cents per gallon. A foreign airline eligible under present law to purchase aviation fuel tax-free would continue to purchase such fuel tax-free.

---

[440] The proposal requires that if such delivery of information is provided to a terminal operator (or if a terminal operator collects such information), that the terminal operator provide such information to the Secretary.

As another example, for an airport that is served by a pipeline, aviation fuel generally is delivered to the wing of an aircraft either by a refueling truck or by a "hydrant" that runs directly from the pipeline to the airplane wing. If a refueling truck that is not licensed for highway use loads fuel from a terminal located within the airport (and the other requirements of the proposal for such truck and terminal are met), and delivers the fuel directly to the wing of an aircraft for use in commercial aviation, the aviation fuel is taxed at 4.4 cents per gallon upon delivery to the wing and the person receiving the fuel is liable for the tax, which such person would be able to self-assess on a return.[441] If fuel is loaded into a refueling truck that does not meet the requirements of the proposal, then the fuel is treated as removed from the terminal into the refueling truck and tax of 21.9 cents per gallon is paid on such removal. The ultimate vendor is entitled to a refund of the difference between 21.9 cents per gallon paid on removal and the rate paid by a commercial airline purchaser (assuming the purchaser waived the refund right). If fuel is removed from a terminal directly to the wing of an aircraft registered to use fuel in commercial aviation by a hydrant or similar device, the person removing the aviation fuel is liable for a tax of 4.4 cents per gallon (or zero in the case of an international flight or qualified foreign airline) and may self-assess such tax on a return.

Under the proposal, a floor stocks tax applies to aviation fuel held by a person (if title for such fuel has passed to such person) on January 1, 2004. The tax is equal to the amount of tax that would have been imposed before January 1, 2004, if the proposal was in effect at all times before such date, reduced by (1) the tax imposed by section 4091, as in effect on the day before such date and, (2) in the case of kerosene held exclusively for the holder's own use, the amount which such holder would reasonably expect under the proposal to be paid as a refund for a nontaxable use with respect to the kerosene. The tax does not apply to kerosene held in the fuel tank of an aircraft on January 1, 2004. The Secretary shall determine the time and manner for payment of the tax, including the nonapplication of the tax on de minimis amounts of aviation fuel. Under the proposal, 0.1 cents per gallon of such tax is transferred to the LUST Trust Fund. The remainder is transferred to the Airport and Airway Trust Fund.

Effective Date

The proposal is effective for aviation fuel removed, entered, or sold after December 31, 2004.

Prior Action

Modification of House bill.

[441] Alternatively, if the aviation fuel in the example is for use in noncommercial aviation, the fuel is taxed at 21.9 cents per gallon upon delivery into the wing. Self-assessment of the tax would not apply in such case.

4. Mechanical dye injection and penalties related to dyeing of fuel

Present Law

Statutory rules

Gasoline, diesel fuel and kerosene are generally subject to excise tax upon removal from a refinery or terminal, upon importation into the United States, and upon sale to unregistered persons unless there was a prior taxable removal or importation of such fuels.[442] However, a tax is not imposed upon diesel fuel or kerosene if all of the following are met: (1) the Secretary determines that the fuel is destined for a nontaxable use, (2) the fuel is indelibly dyed in accordance with regulations prescribed by the Secretary,[443] and (3) the fuel meets marking requirements prescribed by the Secretary.[444] A nontaxable use is defined as (1) any use that is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax, (2) any use in a train, or (3) certain uses in buses for public and school transportation, as described in section 6427(b)(1) (after application of section 6427(b)(3)).[445]

The Secretary is required to prescribe necessary regulations relating to dyeing, including specifically the labeling of retail diesel fuel and kerosene pumps.[446]

A person who sells dyed fuel (or holds dyed fuel for sale) for any use that such person knows (or has reason to know) is a taxable use, or who willfully alters or attempts to alter the dye in any dyed fuel, is subject to a penalty.[447] The penalty also applies to any person who uses dyed fuel for a taxable use (or holds dyed fuel for such a use) and who knows (or has reason to know) that the fuel is dyed.[448] The penalty is the greater of $1,000 per act or $10 per gallon of dyed

---

[442] Sec. 4081(a)(1)(A). If such fuel is used for a nontaxable purpose, the purchaser is entitled to a refund of tax paid, or in some cases, an income tax credit. *See* sec. 6427.

[443] Dyeing is not a requirement, however, for certain fuels under certain conditions, i.e., diesel fuel or kerosene exempted from dyeing in certain States by the EPA under the Clean Air Act, aviation-grade kerosene as determined under regulations prescribed by the Secretary, kerosene received by pipeline or vessel and used by a registered recipient to produce substances (other than gasoline, diesel fuel or special fuels), kerosene removed or entered by a registrant to produce such substances or for resale, and (under regulations) kerosene sold by a registered distributor who sells kerosene exclusively to ultimate vendors that resell it (1) from a pump that is not suitable for fueling any diesel-powered highway vehicle or train, or (2) for blending with heating oil to be used during periods of extreme or unseasonable cold. Sec. 4082(c), (d).

[444] Sec. 4082(a).

[445] Sec. 4082(b).

[446] Sec. 4082(e).

[447] Sec. 6715(a).

[448] Sec. 6715(a).

fuel involved. In determining the amount of the penalty, the $1,000 is increased by the product of $1,000 and the number of prior penalties imposed upon such person (or a related person or predecessor of such person or related person).[449] The penalty may be imposed jointly and severally on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty.[450] For purposes of the penalty, the term "dyed fuel" means any dyed diesel fuel or kerosene, whether or not the fuel was dyed pursuant to section 4082.[451]

Regulations

The Secretary has prescribed certain regulations under this provision, including regulations that specify the allowable types and concentration of dye, that the person claiming the exemption must be a taxable fuel registrant, that the terminal must be an approved terminal (in the case of a removal from a terminal rack), and the contents of the notice to be posted on diesel fuel and kerosene pumps.[452] However, the regulations do not prescribe the time or method of adding the dye to taxable fuel.[453] Diesel fuel is usually dyed at a terminal rack by either manual dyeing or mechanical injection. The regulations also provide that a terminal operator is jointly and severally liable for unpaid tax if undyed diesel fuel or kerosene is removed and the terminal operator provides any person with documentation that such fuel is dyed.[454]

Description of Proposal

With respect to terminals that offer dyed fuel, the proposal eliminates manual dyeing of fuel and requires dyeing by a mechanical system. Not later than 180 days after the date of enactment, the Secretary of the Treasury is to prescribe regulations establishing standards for tamper resistant mechanical injector dyeing. Such standards shall be reasonable, cost-effective, and establish levels of security commensurate with the applicable facility.

The proposal adds an additional set of penalties for violation of the new rules. A penalty, equal to the greater of $25,000 or $10 for each gallon of fuel involved, applies to each act of tampering with a mechanical dye injection system. The person committing the act is also

---

[449] Sec. 6715(b).

[450] Sec. 6715(d).

[451] Sec. 6715(c)(1).

[452] Treas. Reg. secs. 48.4082-1, -2.

[453] In March 2000, the IRS withdrew its Notice of Proposed Rulemaking PS-6-95 (61 F.R. 10490 (1996)) relating to dye injection systems. Announcement 2000-42, 2000-1 C.B. 949. The proposed regulation established standards for mechanical dye injection equipment and required terminal operators to report nonconforming dyeing to the IRS. *See also* Treas. Reg. sec. 48.4082-1(c), (d).

[454] Treas. Reg. sec. 48.4081-2(c).

responsible for any unpaid tax on removed undyed fuel. A penalty of $1,000 is imposed upon the operator of a mechanical dye injection system for each failure to maintain the security standards for such system.[455] An additional penalty of $1,000 is imposed upon such operator for each day any such violation remains uncorrected after the first day such violation has been or reasonably should have been discovered. For purposes of the daily penalty, a violation may be corrected by shutting down the portion of the system causing the violation. If any of these penalties are imposed on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty. If such business entity is part of an affiliated group, the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty.

The proposal denies administrative appeal or review for repeat offenders (more than two violations) of present law after a chemical analysis of the fuel, except in the case of a claim regarding fraud or mistake in the chemical analysis or error in the mathematical calculation of the amount of penalty. The proposal also extends present-law penalties to any person who knows that the strength or composition of any dye or marking in any dyed fuel has been altered, chemically or otherwise, and who sells (or holds for sale) such fuel for any use that the person knows or has reason to know is a taxable use of such fuel.

Effective Date

The proposal related to mechanical dyeing, including related penalties, is effective 180 days after the date that the Secretary issues the required regulations. The Secretary must issue such regulations no later than 180 days after enactment. The proposal relating to the denial of certain administrative review is effective for penalties assessed after date of enactment. The proposal extending present-law penalties is effective on date of enactment.

Prior Action

The proposal relating to mechanical dyeing, including related penalties, is the same as the House bill and the Senate amendment, except the House effective date is adopted. The proposals relating to the denial of certain administrative review and extending present-law penalties are the same as the Senate amendment.

5. Terminate dyed diesel use by intercity buses

Present Law

A manufacturer's tax of 24.4 cents per gallon applies to diesel fuel.[456] Diesel fuel that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Use in an intercity bus is a nontaxable use for purposes of the

[455] The terminal operator remains liable under current Treas. Reg. sec. 48.4081-2(c) for any unpaid tax on removed undyed fuel.

[456] Sec. 4081.

manufacturers tax on diesel fuel. However, diesel fuel is subject to a retail backup tax. The retail tax is 7.4 cents per gallon for intercity buses, but only applies if no tax was imposed on the diesel under the manufacturers tax.[457] Thus, dyed diesel removed from the terminal is exempt from the manufacturers tax but a tax of 7.3 cents per gallon (plus .1 for LUST) is imposed on the delivery of the dyed fuel into the fuel supply tank of the intercity bus. The operator of the bus is liable for the tax.

Under present law, intercity bus operators also may buy fully taxed undyed diesel and seek a refund of the difference between the 24.4 cents per gallon rate and the 7.3 cents per gallon rate.

Description of Proposal

The proposal eliminates the ability of intercity buses to buy dyed diesel and self-assess the 7.4 cents per gallon. Under the proposal, operators of such buses must buy clear fuel and seek a refund of the difference between 24.4 and 7.4 cents per gallon of tax on diesel fuel. The proposal permits refund claimants to obtain interest if they file their refund claims electronically and the Secretary does not pay such claims within 20 days. The proposal also permits ultimate vendors to make such refund claims if the bus operator assigns its right to claim a refund to the ultimate vendor.

Effective Date

The proposal is effective for fuel sold after December 31, 2004.

Prior Action

Modification of Senate amendment.

6. Authority to inspect on-site records

Present Law

The IRS is authorized to inspect any place where taxable fuel[458] is produced or stored (or may be stored). The inspection is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[459]

In conducting the inspection, the IRS may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks.

---

[457] Sec. 4041(a)(1)(B) and sec. 4041(a)(1)(C)(III)(i).

[458] "Taxable fuel" means gasoline, diesel fuel, and kerosene. Sec. 4083(a).

[459] Sec. 4083(c)(1)(A).

The scope of the inspection includes the book and records kept at the place of inspection to determine the excise tax liability under section 4081.[460]

Description of Proposal

The proposal expands the scope of the inspection to include any books, records, or shipping papers pertaining to taxable fuel located in any authorized inspection location.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Same as House bill and Senate amendment.

7. Assessable penalty for refusal of entry

Present Law

The Internal Revenue Service is authorized to inspect any place where taxable fuel is produced or stored (or may be stored). As part of the inspection, the Internal Revenue Service is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection, include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[461]

In conducting the inspection, the Internal Revenue Service may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept to determine the excise tax liability under section 4081.[462] The Internal Revenue Service is authorized to establish inspection sites. A designated inspection site includes any State highway inspection station, weigh station, agricultural inspection station, mobile station or other location designated by the Internal Revenue Service.[463]

Any person that refuses to allow an inspection is subject to a penalty in the amount of $1,000 for each refusal.[464] The IRS is not able to assess this penalty in the same manner as it would a tax. It must first seek the assistance of the Department of Justice to obtain a judgment.

---

[460] Treas. Reg. sec. 48.4083-1(c)(1).

[461] Sec. 4083(c)(1)(A).

[462] Treas. Reg. sec. 48.4083-1(b)(2).

[463] Sec. 4083(c); Treas. Reg. sec. 48.4083-1(b)(1).

[464] Sec. 4083(c)(3) and 7342.

Assessable penalties are payable upon notice and demand by the Secretary and are assessed and collected in the same manner as taxes.[465]

Description of Proposal

In addition to the $1,000 penalty under present law, an assessable penalty is imposed with respect to the refusal of entry of any person with the intent to transport and distribute untaxed, adulterated fuel mixtures or to transport and distribute dyed diesel fuel for taxable use. The assessable penalty is $1,000 for such refusal. The penalty will not apply if it is shown that such failure is due to reasonable cause. If the penalty is imposed on a business entity, the proposal provides for joint and several liability with respect to each officer, employee, or agent of such entity or other contracting party who willfully participated in the act giving rise to the penalty. If the business entity is part of an affiliated group, the parent corporation also will be jointly and severally liable for the penalty.

Effective Date

The proposal is effective on January 1, 2005.

Prior Action

Same as Senate amendment except for effective date.

8. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries

Present Law

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[466] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") to a terminal or refinery if both the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[467]

Present law does not require that the vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered refiner may transfer fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer to an unregistered person.

---

[465] Sec. 6671.

[466] Sec. 4081(a)(1)(A).

[467] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

In general, the owner of the fuel is liable for payment of tax with respect to bulk transfers not received at an approved terminal or refinery.[468] The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.[469]

Description of Proposal

The proposal requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax.

The Secretary is required to publish periodically a current list of all registered persons who are required to register. The Secretary shall publish such list pursuant to section 6103(k)(7).

Effective Date

The proposal is effective on March 1, 2005, except that the Secretary is required to publish the list of registered persons beginning on January 1, 2005.

Prior Action

Modification of House bill.

9. Display of registration and penalties for failure to display registration and to register

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[470] A non assessable penalty for failure to register is $50.[471] A criminal penalty of $5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[472]

Description of Proposal

The proposal requires that every operator of a vessel who is required to register with the Secretary display on each vessel used by the operator to transport fuel, proof of registration

---

[468] Treas. Reg. sec. 48.4081-3(e)(2).

[469] Treas. Reg. sec. 48.4081-3(b).

[470] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

[471] Sec. 7272(a).

[472] Sec. 7232.

through an identification device prescribed by the Secretary. A failure to display such proof of registration results in a penalty of $500 per month per vessel. The amount of the penalty is increased for multiple prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

The proposal imposes a new assessable penalty for failure to register of $10,000 for each initial failure, plus $1,000 per day that the failure continues. No penalty is imposed upon a showing by the taxpayer of reasonable cause. In addition, the proposal increases the present law non assessable penalty for failure to register from $50 to $10,000 and the present law criminal penalty for failure to register from $5,000 to $10,000. The proposal authorizes amounts equivalent to any of such penalties received to be appropriated to the Highway Trust Fund.

Effective Date

The proposal requiring display of registration is effective on January 1, 2005. The proposal relating to penalties is effective for penalties imposed after December 31, 2004.

Prior Action

Modification of House bill.

10. Registration of persons within foreign trade zones

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[473]

Description of Proposal

Under the proposal, the Secretary shall require registration by any person that operates a terminal or refinery within a foreign trade zone or within a customs bonded storage facility. It is intended that the Secretary shall establish a date by which persons required to register must be registered.

Effective Date

The proposal is effective on January 1, 2005.

Prior Action

Same as Senate amendment except for effective date.

[473] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

11. Penalties for failure to report

Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.[474] Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[475] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements. In general, the penalty for failure to file a report or a failure to furnish all of the required information in a report is $50 per report.[476]

Description of Proposal

The proposal imposes a new assessable penalty for failure to file a report or to furnish information required in a report required by the ExSTARS system. The penalty is $10,000 per failure with respect to each vessel or facility (e.g., a terminal or other facility) for which information is required to be furnished. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

Effective Date

The proposal regarding penalties is effective for penalties imposed after December 31, 2004.

Prior Action

Same as House bill and Senate amendment except for effective date.

12. Electronic information reporting

Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly

---

[474] Sec. 4101(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

[475] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

[476] Sec. 6721(a).

on the movement of any liquid product into or out of an approved terminal.[477] Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[478] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements.

Description of Proposal

The proposal requires any person who must report under the ExSTARs systems and who has 25 or more reportable transactions in a month to report in electronic format.

Effective Date

The proposal is effective on January 1, 2006.

Prior Action

Modification of Senate amendment.

13. Taxable fuel refunds for certain ultimate vendors

Present Law

The Code provides that, in the case of gasoline on which tax has been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, a wholesale distributor that sells the gasoline for such exempt purposes is treated as the person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid. In the case of undyed diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, a credit or payment is allowable only to the ultimate, registered vendors ("ultimate vendors") of such fuels.

In general, refunds are paid without interest. However, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, the Secretary is required to pay interest on certain refunds. The Secretary must pay interest on refunds of $200 or more ($100 or more in the case of kerosene) due to the taxpayer arising from sales over any period of a week or more, if the Secretary does not make payment of the refund within 20 days.

[477] Sec. 4101(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

[478] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

Description of Proposal

For sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, the proposal conforms the payment of refunds to that procedure established under present law in the case of diesel fuel or kerosene. That is, the ultimate vendor claims for refund.

The proposal modifies the payment of interest on refunds. Under the proposal, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, all refunds unpaid after 45 days must be paid with interest. If the taxpayer has filed for his or her refund by electronic means, refunds unpaid after 20 days must be paid with interest.

Effective Date

The proposal is effective on January 1, 2005.

Prior Action

Modifies House bill and Senate amendment.

14. Two-party exchanges

Present Law

Most fuel is taxed when it is removed from a registered terminal.[479] The party liable for payment of this tax is the "position holder." The position holder is the person reflected on the records of the terminal operator as holding the inventory position in the fuel.[480]

It is common industry practice for oil companies to serve customers of other oil companies under exchange agreements, *e.g.*, where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) owns the fuel when the motor fuel is removed from the terminal and sold to B's customer.

---

[479] A "terminal" is a storage and distribution facility that is supplied by pipeline or vessel, and from which fuel may be removed at a rack. A "rack" is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel.

[480] Such person has a contractual agreement with the terminal operator to store and provide services with respect to the fuel. A "terminal operator" is any person who owns, operates, or otherwise controls a terminal. A terminal operator can also be a position holder if that person owns fuel in its terminal.

Description of Proposal

The proposal permits two registered parties to switch position holder status in fuel within a registered terminal (thereby relieving the person originally owning the fuel[481] of tax liability as the position holder) if all of the following occur:

(1) The transaction includes a transfer from the original owner, i.e., the person who holds the original inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator prior to the transaction.

(2) The exchange transaction occurs before or at the same time as completion of removal across the rack from the terminal by the receiving person or its customer.

(3) The terminal operator in its books and records treats the receiving person as the person that removes the product across a terminal rack for purposes of reporting the transaction to the Internal Revenue Service.

(4) The transaction is the subject of a written contract.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

Same as House bill and Senate amendment.

15. Modification of the use tax on heavy highway vehicles

Present Law

An annual use tax is imposed on heavy highway vehicles, at the rates below.[482]

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers

[481] In the proposal, this person is referred to as the "delivering person."

[482] Sec. 4481.

are allowed to pay the tax in installments.[483] State governments are required to receive proof of payment of the use tax as a condition of vehicle registration.

Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[484] Any highway motor vehicle that is issued a base plate by Canada or Mexico and is operated on U.S. highways is subject to the highway use tax whether or not the vehicles are required to be registered in the United States. The tax rate for Canadian and Mexican vehicles is 75 percent of the rate that would otherwise be imposed.[485]

Description of Proposal

The proposal eliminates the ability to pay the tax in installments. It also eliminates the reduced rates for Canadian and Mexican vehicles. The proposal requires taxpayers with 25 or more vehicles for any taxable period to file their returns electronically. Finally, the proposal permits proration of tax for vehicles sold during the taxable period.

Effective Date

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

Prior Action

Same as the House bill.

16. Dedication of revenues from certain penalties to the Highway Trust Fund

Present Law

Present law does not dedicate to the Highway Trust Fund any penalties assessed and collected by the Secretary.

Description of Proposal

The proposal dedicates to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715 (relating to dyed fuel sold for use or used in taxable use), 6715A (penalty for tampering with or failing to maintain security requirements for mechanical dye injection systems), 6717 (assessable penalty for refusal of entry), 6718 (penalty for failing to display tax registration on vessels), 6719 (assessable penalty for failure to register), 6725 (penalty for failing to report information required by the Secretary), 7232 (penalty for failing to

[483] Sec. 6156.

[484] See generally, sec. 4483.

[485] Sec. 4483(f): Treas. Reg. sec. 41.4483-7(a).

register and false representations of registration status), and 7272 (but only with regard to penalties related to failure to register under section 4101).

Effective Date

The proposal is effective for penalties assessed on or after the date of enactment.

Prior Action

Same as House bill and Senate amendment except for effective date, which was effective for penalties assessed after October 1, 2004.

17. Simplification of tax on tires

Present Law

A graduated excise tax is imposed on the sale by a manufacturer (or importer) of tires designed for use on highway vehicles (sec. 4071). The tire tax rates are as follows:

Tire Weight	Tax Rate
Not more than 40 lbs.	No tax
More than 40 lbs., but not more than 70 lbs.	15 cents/lb. in excess of 40 lbs.
More than 70 lbs., but not more than 90 lbs.	$4.50 plus 30 cents/lb. in excess of 70 lbs.
More than 90 lbs.	$10.50 plus 50 cents/lb. in excess of 90 lbs.

No tax is imposed on the recapping of a tire that previously has been subject to tax. Tires of extruded tiring with internal wire fastening also are exempt.

The tax expires after September 30, 2005.

Description of Proposal

The proposal modifies the excise tax applicable to tires. The proposal replaces the present-law tax rates based on the weight of the tire with a tax rate based on the load capacity of the tire. In general, the tax is 9.45 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. In the case of a biasply tire or super single tire, the tax rate is 4.725 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds.

The proposal modifies the definition of tires for use on highway vehicles to include any tire marked for highway use pursuant to certain regulations promulgated by the Secretary of Transportation. The proposal also exempts from tax any tire sold for the exclusive use of the United States Department of Defense or the United States Coast Guard.

Tire load capacity is the maximum load rating labeled on the tire pursuant to regulations promulgated by the Secretary of Transportation. A “bias ply tire” is a pneumatic tire on which

the ply cords that extend to the beads are laid at alternate angles substantially less than 90 degrees to the centerline of the tread. A "super single tire" means a single tire greater than 13 inches in cross section width designed to replace two tires in a dual fitment.

Effective Date

The proposal is effective for sales in calendar years beginning more than 30 days after the date of enactment.

Prior Action

Modifies the House bill.

18. Transmix and diesel fuel blendstocks treated as taxable fuel

Present law

Definition of taxable fuels

A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[486]

Under the regulations, "gasoline" includes all products commonly or commercially known or sold as gasoline and suited for use as a motor fuel, and that have an octane rating of 75 or more. Gasoline also includes, to the extent provided in regulations, gasoline blendstocks and products commonly used as additives in gasoline. The term "gasoline blendstocks" does not include any product that cannot be blended into gasoline without further processing or fractionation ("off-spec gasoline").[487]

Diesel fuel is any liquid (other than gasoline) that is suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train.[488] By regulation, diesel fuel does not include kerosene, gasoline, No. 5 and No. 6 fuel oils (as described in ASTM Specification D 396), or F-76 (Fuel Naval Distillates MIL-F-16884) any liquid that contains less than four percent normal parafins, or any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur

[486] Sec. 4083(a).

[487] Treas. Reg. sec. 48.4081-1(c)(3)(ii). The term "gasoline blendstocks" means alkylate; butane; catalytically cracked gasoline; coker gasoline; ethyl tertiary butyl ether (ETBE); hexane; hydrocrackate; isomerate; methyl tertiary butyl ether (MTBE); mixed xylene (not including any separated isomer of xylene); natural gasoline; pentane; pentane mixture; polymer gasoline; raffinate; reformate; straight-run gasoline; straight-run naphtha; tertiary amyl methyl ether (TAME); tertiary butyl alcohol (gasoline grade) (TBA); thermally cracked gasoline; toluene; and transmix containing gasoline. Treas. Reg. sec. 48.4081-1(c)(3)(i).

[488] Sec. 4083(a)(3).

content of 10 ppm or less and minimum color of +27 Saybolt (these are known as "excluded liquids").[489]

By regulation, kerosene is defined as the kerosene described in ASTM Specification D 3699 (No. 1-K and No. 2-K), ASTM Specification D 1655 (kerosene-type jet fuel), and military specifications MIL-DTL-5624T (Grade JP-5) and MIL-DTL- 83133E (Grade JP-8). Kerosene does not include any liquid that is an excluded liquid.[490]

Taxable events and exemptions

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[491] The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[492]

Gasoline exemptions

If certain conditions are met, the removal, entry, or sale of gasoline blendstocks is not taxable. Generally, the exemption from tax applies if a gasoline blendstock is not used to produce finished gasoline or is received at an approved terminal or refinery. No tax is imposed on nonbulk removals from a terminal or refinery, or nonbulk entries into the United States or on any gasoline blendstocks if the person liable for the tax is a gasoline registrant, has an unexpired notification certificate, knows of no false information in the certificate, and has verified the accuracy of the notification certificate. The sale of a gasoline blendstock that was not subject to tax on nonbulk removal or entry is taxable unless the seller has an unexpired certificate from the buyer and has no reason to believe that any information in the certificate is false. No tax is imposed on, or purchaser certification required for, off-spec gasoline.

Diesel fuel and kerosene exemptions

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Undyed aviation-grade kerosene also is exempt from tax at the rack if it is destined for use as a fuel in an aircraft. The tax does not apply to diesel fuel asserted to be "not suitable for use" or kerosene asserted to qualify as an excluded liquid.

---

[489] Treas. Reg. sec. 48.4081-1(c)(2)(ii).

[490] Treas. Reg. sec. 48.4081-1(b).

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

[492] Sec. 4081(a)(1)(B).

Feedstock kerosene that a registered industrial user receives by pipeline or vessel also is exempt from the dyeing requirement. A kerosene feedstock user is defined as a person that receives kerosene by bulk transfer for its own use in the manufacture or production of any substance (other than gasoline, diesel fuel or special fuels subject to tax). Thus, for example, kerosene is used for a feedstock purpose when it is used as an ingredient in the production of paint and is not used for a feedstock purpose when it is used to power machinery at a factory where paint is produced. The person receiving the kerosene must be registered with the IRS and provide a certificate noting that the kerosene will be used for a feedstock purpose in order for the exemption to apply.

Description of Proposal

The proposal adds two new categories to the definition of diesel fuel. Under the proposal, diesel fuel means: (1) any liquid (other than gasoline) which is suitable for use as a fuel in a diesel-powered highway vehicle, or a diesel-powered train; (2) transmix; and (3) diesel fuel blend stocks as identified by the Secretary. Transmix means a by-product of refined products pipeline operations created by the mixing of different specification products during pipeline transportation. Transmix generally results when one fuel, such as diesel fuel, is placed in a pipeline followed by another taxable fuel, such as kerosene. The mixture created between the two fuels when it is neither all diesel fuel nor all kerosene, is an example of a transmix. Under the proposal, all transmix is taxable as diesel fuel, regardless of whether it contains gasoline.

Under the proposal, it is intended that the re-refining of tax-paid transmix into gasoline, diesel fuel or kerosene qualify as a nontaxable off-highway business use of such transmix, for purposes of the refund and payment provisions relating to nontaxable uses of diesel fuel.

Effective Date

The proposal is effective for fuel removed, sold, or used after December 31, 2004.

Prior Action

Modification of Senate amendment.

19. Treasury study on taxable fuel compliance

Present Law

Present law does not require the Secretary to report on issues regarding fuel fraud and compliance issues.

Description of Proposal

Not later than January 31, 2005, the Secretary shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report regarding fuel tax compliance, which shall include information, and analysis as specified below, and recommendations to address the issues identified.

Taxable fuel blendstocks

The Secretary is to identify chemical products that should be added to the list of blendstocks. The Secretary is to identify those chemical products, as identified by lab analysis of fuel samples taken by the IRS, that have been blended with taxable fuel but are not currently treated as a blendstock. The report should indicate, to the extent possible, any statistics as to the frequency in which such chemical product has been discovered, and whether the samples contained above-normal concentrations of such chemical product.

Waste products added to taxable fuel

The report also shall include a discussion of IRS findings regarding the addition of waste products to taxable fuel and any recommendations to address the taxation of such products.

Erroneous claims of fuel tax exemption

The report shall include a discussion of IRS findings regarding sales of taxable fuel to entities claiming exempt status as a State or local government. Such discussion shall include the frequency of erroneous certifications as to exempt status determined on audit. The Secretary shall consult with representatives of State and local governments in providing recommendations to address this issue, including the feasibility of State maintained lists of their exempt governmental entities.

Effective Date

The proposal is effective on the date of enactment.

Prior Action

None.

D. Other Revenue Provisions

1. Permit private sector debt collection companies to collect tax debts

Present Law

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. That provision does not apply to the collection of debts under the Internal Revenue Code.

Description of Proposal

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities and to arrange payment of those taxes by the taxpayers. 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 five years. If the taxpayer is unable to pay the outstanding tax liability in full over a five-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS. The proposal also provides that up to 25 percent of amount collected may be used for IRS collection enforcement activities and requires a biennial report.

The proposal creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies would be paid out of this fund.

Effective Date

Date of enactment.

Prior Action

Modification of House bill and Senate amendment.

2. Modify charitable contribution rules for donations of patents and other intellectual property

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[493] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

[493] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets, in which case the charitable deduction for such copyrights generally is limited to the taxpayer's basis.[494]

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.[495] 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.[496] 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.[497]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[498] Under

---

[494] *See* sec. 1221(a)(3), 1231(b)(1)(C).

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

[496] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

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

[498] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for

Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[499] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[500]

Description of Proposal

The proposal provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property. For this purpose, "qualified donee income" includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income received or accrued by the charitable donee that properly is allocable to the contributed property to the applicable taxable year of the donor, determined as follows:

Taxable Year of Donor	Deduction Permitted for Such Taxable Year
1st year ending on or after contribution	100 percent of qualified donee income
2nd year ending on or after contribution	100 percent of qualified donee income
3rd year ending on or after contribution	90 percent of qualified donee income
4th year ending on or after contribution	80 percent of qualified donee income
5th year ending on or after contribution	70 percent of qualified donee income

---

the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[499] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[500] Treas. Reg. sec. 1.170A-13(c)(3).

Taxable Year of Donor	Deduction Permitted for Such Taxable Year
6th year ending on or after contribution	60 percent of qualified donee income
7th year ending on or after contribution	50 percent of qualified donee income
8th year ending on or after contribution	40 percent of qualified donee income
9th year ending on or after contribution	30 percent of qualified donee income
10th year ending on or after contribution	20 percent of qualified donee income
11th year ending on or after contribution	10 percent of qualified donee income
12th year ending on or after contribution	10 percent of qualified donee income
Taxable years thereafter	No deduction permitted

An additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated pursuant to the sliding-scale exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property.

No charitable deduction is permitted with respect to any revenues or income received or accrued by the charitable donee after the expiration of the legal life of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer is required to inform the donee at the time of the contribution that the taxpayer intends to treat the contribution as a contribution subject to the additional charitable deduction provisions of the proposal. In addition, the taxpayer must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the charity's taxable year.[501] The donee is required to file an annual information return that reports the qualified donee income and other specified information relating to the contribution. In instances where the donor's taxable year differs from the donee's taxable year, the donor bases its additional charitable deduction on the qualified donee income of the charitable donee properly allocable to the donee's taxable year that ends within the donor's taxable year.

Under the proposal, additional charitable deductions are not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation or certain other private foundations described in section 170(b)(1)(E)).

Under the proposal, the Secretary may prescribe regulations or other guidance to carry out the purposes of the proposal, including providing for the determination of amounts to be treated as qualified donee income in certain cases where the donee uses the donated property to

[501] The net income taken into account by the taxpayer may not exceed the amount of qualified donee income reported by the donee to the taxpayer and the IRS under the proposal's substantiation and reporting requirements.

further its exempt activities or functions, or as may be necessary or appropriate to prevent the avoidance of the purposes of the proposal.

Effective Date

The proposal is effective for contributions made after June 3, 2004.

Prior Action

Same as House bill.

3. Require increased reporting for noncash charitable contributions

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.[502] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Taxpayers are required to obtain a qualified appraisal for donated property (other than money and publicly traded securities) with a value of more than $5,000.[503] Corporations (other than a closely-held corporation, a personal service corporation, or an S corporation) are not required to obtain a qualified appraisal. Taxpayers are not required to attach a qualified appraisal to the taxpayer's return, except in the case of contributed art-work valued at more than $20,000.

---

[502] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[503] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and taxpayer identification number of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[504] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[505]

Description of Proposal

The proposal requires increased donor reporting for certain charitable contributions of property other than cash, inventory, publicly traded securities, or certain vehicles. The proposal extends to all C corporations the present law requirement, applicable to an individual, closely-held corporation, personal service corporation, partnership, or S corporation, that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. The proposal also provides that if the amount of the contribution of property exceeds $500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor's tax return. For purposes of the dollar thresholds under the proposal, property and all similar items of property donated to one or more donees are treated as one property.

The proposal provides that a donor that fails to substantiate a charitable contribution of property, as required by the Secretary, is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. The denial of the deduction does not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

The proposal provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations that may provide that some or all of the requirements of the proposal do not apply in appropriate cases.

Effective Date

The proposal is effective for contributions made after June 3, 2004.

Prior Action

Same as House bill.

---

[504] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[505] Treas. Reg. sec. 1.170A-13(c)(3).

4. Limit deduction for charitable contributions of vehicles

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.[506] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to determine the deductible amount by subtracting any gain from fair market value, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

A taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer's basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as boats.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[507] Under

---

[506] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[507] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98-369, a qualified appraisal means an appraisal prepared by a

Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[508] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[509]

Description of Proposal

Under the proposal, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction shall not exceed the gross proceeds received from the sale.

The proposal imposes new substantiation requirements for contributions of vehicles for which the claimed value exceeds $500 (excluding inventory). A deduction is not allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement by the donee. The acknowledgement must contain the name and taxpayer identification number of the donor and the vehicle identification number (or similar number) of the vehicle. In addition, if the donee sells the vehicle without performing a significant intervening use or material improvement of such vehicle, the acknowledgement must provide a certification that the vehicle was sold in an arm's length transaction between unrelated parties, and state the gross proceeds from the sale and that the deductible amount may not exceed such gross proceeds. In all other cases, the acknowledgement must contain a certification of the intended use or material improvement of the vehicle and the intended duration of such use, and a certification that the vehicle will not be transferred in exchange for money, other property, or services before completion of such use or improvement. The donee must notify the Secretary of the information contained in an acknowledgement, in a time and manner provided by the Secretary. An acknowledgement is considered contemporaneous if provided within 30 days of sale of a vehicle

---

qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[508] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[509] Treas. Reg. sec. 1.170A-13(c)(3).

that is not significantly improved or materially used by the donee, or, in all other cases, within 30 days of the contribution.

A penalty applies if a donee organization knowingly furnishes a false or fraudulent acknowledgement, or knowingly fails to furnish an acknowledgement in the manner, at the time, and showing the required information. In the case of an acknowledgement provided within 30 days of sale of a vehicle which is not significantly used or materially improved by the donee, the penalty is the greater of the product of the highest rate of tax specified in section 1 and the sales price stated on the acknowledgement or the gross proceeds from the sale of the vehicle. For all other acknowledgements, the penalty is the greater of the product of the highest rate of tax specified in section 1 and the claimed value of the vehicle or $5,000.

The proposal provides that the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of the proposal. The Secretary also may prescribe regulations or other guidance that exempts sales of vehicles that are in direct furtherance of the donee's charitable purposes from the requirement that the donor may not deduct an amount in excess of the gross proceeds from the sale, and the requirement that the donee certify that the vehicle will not be transferred in exchange for money, other property, or services before completion of a significant use or material improvement by the donee.

Effective Date

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

Prior Action

Modification of Senate amendment.

5. Treatment of nonqualified deferred compensation plans

Present Law

In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[510] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the

[510] *See, e.g., Sproull v. Commissioner,* 16 T.C. 244 (1951), *aff'd per curiam,* 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[511] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[512] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi trusts

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified

[511] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

[512] Treas. Reg. secs. 1.451-1 and 1.451-2.

deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[513] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.[514] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which attempt to allow deferred amounts to be available to individuals, while still purporting to meet the safe harbor requirements set forth by the IRS.

Description of Proposal

In general

Under the proposal, all amounts deferred under a nonqualified deferred compensation plan[515] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[516] and not previously included in gross income, unless certain

---

[513] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[514] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

[515] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[516] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

requirements are satisfied.[517] If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Current income inclusion, interest, and the additional tax apply only with respect to the participants with respect to whom the requirements of the proposal are not met. For example, suppose a plan covering all executives of an employer (including those subject to section 16 of the Securities and Exchange Act of 1934) allows distributions to individuals subject to section 16 upon a distribution event that is not permitted under the proposal. The individuals subject to section 16, rather than all participants of the plan, would be required to include amounts deferred in income and would be subject to interest and the 20-percent additional tax.

Permissible distributions

In general

Under the proposal, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution.

Separation from service

In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees[518] of publicly-traded corporations.

Specified time

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an

[517] It is intended that Treasury regulations will provide guidance regarding when an amount is deferred. It is intended that timing of an election to defer is not determinative of when the deferral is made.

[518] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Change in control

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the proposal. The proposal requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

Unforeseeable emergency

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

Disability

A participant is considered disabled if he or she (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (2) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

Prohibition on acceleration of distributions

As mentioned above, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, it is intended that the rule against accelerations is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump-sum payment may be permitted. It is also intended that the Secretary provide rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted.

It is intended that the Secretary will provide other, limited, exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. For example, it is anticipated that an exception could be provided if a distribution is needed in order to comply with Federal conflict of interest requirements or court-approved settlements. It is also intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing that withholding of an employee's share of employment taxes will be made from the employee's nonqualified deferred compensation account or by providing for automatic distributions of minimal account balances upon permissible distribution events for purposes of administrative convenience. For example, a plan could provide that upon separation from service of a participant, account balances less than $10,000 will be automatically distributed (except in the case of specified employees).

Requirements with respect to elections

The proposal requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations.[519] In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. It is expected that the Secretary will issue guidance providing rules regarding the timing of elections in the case when the fiscal year of the employer and the taxable year of the individual are different and a bonus is determined on the basis of the employer's fiscal year. For example, Treasury guidance could provide that the election requirement is satisfied in such case if the election is required to be made prior to the end of the close of the employer's preceding fiscal year. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the proposal.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the proposal. It is intended that multiple payout events are permissible. For example, a participant could elect to receive 25 percent of their account balance at age 50 and the remaining 75 percent at age 60. A plan could also allow participants to elect different forms of payment for different permissible distribution events. For example, a participant could elect to receive a lump-sum distribution upon disability, but an annuity at age 65.

[519] Under the proposal, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

Under the proposal, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary shall issue guidance, consistent with the purposes of the proposal, regarding to what extent elections to change a stream of payments are permissible.

Foreign trusts

Under the proposal, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax. It is expected that the Secretary will provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The proposal does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The proposal is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. The Secretary has authority to exempt arrangements from the proposal if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Triggers upon financial health

Under the proposal, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the

case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. The proposal applies in the case of plan that provides that upon a change in financial health, assets will be transferred to a rabbi trust. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Definition of nonqualified deferred compensation plan

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[520] A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan under the proposal. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan. The application of the proposal is not limited to arrangements between an employer and employee.

For purposes of the provision, it is not intended that the term "nonqualified deferred compensation plan" include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future.

The proposal does not apply to a plan meeting the requirements of section 457(e)(12) if the plan was in existence as of May 1, 2004, was providing nonelective deferred compensation described in section 457(e)(12) on such date, and had received a favorable determination letter from the IRS on or before such date. If the plan has a material change in the class of individuals eligible to participate in the plan after May 1, 2004, the proposal applies to compensation provided under the plan after the date of such change.

Other rules

Interest imposed under the proposal is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the proposal. The proposal is not intended to prevent the inclusion of amounts in gross income under any proposal or rule of law earlier

[520] A qualified employer plan also includes a section 501(c)(18) trust.

than the time provided in the proposal. Any amount included in gross income under the proposal shall not be required to be included in gross income under any provision of law later than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

Treasury regulations

The proposal provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of proposal, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the proposals providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture. It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used in a manner inconsistent with the purposes of the proposal. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

Aggregation rules

Under the proposal, except as provided by the Secretary, employer aggregation rules apply. It is intended that the Secretary issue guidance providing aggregation rules as are necessary to carry out the purposes of the proposal. For example, it is intended that aggregation rules would apply in the case of separation from service so that the separation from service from one entity within a controlled group but continued service for another entity within the group would not be a permissible distribution event. It is also intended that aggregation rules would not apply in the case of change in control so that the change in control of one member of a controlled group would not be a permissible distribution event for participants of a deferred compensation plan of another member of the group.

Reporting requirements

Amounts required to be included in income under the proposal are subject to reporting and Federal income tax withholding requirements. Amounts required to be includible in income are required to be reported on an individual's Form W-2 (or Form 1099) for the year includible in income.

The proposal also requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year. It is expected that annual reporting of annual amounts deferred will provide the IRS greater information regarding such arrangements for enforcement purposes. It is intended that the information reported would provide an indication of what arrangements should be examined and challenged. Under the proposal, the Secretary is authorized, through regulations, to establish

a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[521]

Effective Date

The proposal is effective for amounts deferred in taxable years beginning after December 31, 2004. Earnings on amounts deferred before the effective date are subject to the proposal to the extent that such amounts deferred are subject to the proposal.

Amounts deferred in taxable years beginning before January 1, 2005, are subject to the proposal if the plan under which the deferral is made is materially modified after October 3, 2004. For example, a plan materially modified on November 1, 2004, to add a provision that distributions may be allowed upon request if participants are required to forfeit 10 percent of the amount of the distribution (i.e., a "haircut" provision) would be subject to the proposal. Subsequent deferrals under a plan that is not materially modified after October 3, 2004, would be subject to present law and would not be subject to the proposal.[522] No inference is intended that all deferrals before the effective date are permissible under present law. It is expected that the IRS will challenge pre-effective date deferral arrangements that do not comply with present law.

No later than 60 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation plan adopted before December 31, 2004, may, without violating the requirements of the proposal relating to distributions, accelerations, and elections (1) be amended to permit that a participant may terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if such amounts are includible in income as earned, or if later, when not subject to a substantial risk of forfeiture or (2) be amended to conform with the proposal with respect to amounts deferred after December 31, 2004. It is expected that the Secretary may provide exceptions to certain requirements of the proposal during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the proposal.

Prior Action

Modification of House bill and Senate amendment.

---

[521] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

[522] There is no inference that all subsequent deferrals elections under plans that are not materially modified are permissible under present law.

6. Extend the present-law intangible amortization provisions to acquisitions of sports franchises

Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[523] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[524] 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.[525] 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.

Description of Proposal

The proposal would extend 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

---

[523] Sec. 197.

[524] Sec. 197(e)(6).

[525] *P.D.B. Sports, Ltd. v. Comm.*, 109 T.C. 423 (1997).

acquisitions of sports franchises. The proposal also would repeal the special rules under section 1245(a)(4) and make other conforming changes.

Effective date

The proposal would be effective for property acquired after the date of enactment. The amendment to section 1245(a)(4) would apply to franchises acquired after the date of enactment.

Prior Action

Same as House bill and Senate amendment.

7. Increase continuous levy for certain federal payments

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[526] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[527] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[528]

A continuous levy is applicable to specified Federal payments.[529] This includes any Federal payment for which eligibility is not based on the income and/or assets of a payee. Thus, a Federal payment to a vendor of goods or services to the government is subject to continuous levy. This continuous levy attaches up to 15 percent of any specified payment due the taxpayer.

Description of Proposal

The bill permits a levy of up to 100 percent of a Federal payment to a vendor of goods or services to the Federal Government.

Effective Date

Date of enactment.

---

[526] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[527] Code sec. 6331.

[528] Code secs. 6335-6343.

[529] Code sec. 6331(h).

Prior Action

Same as House bill and Senate amendment.

8. Modification of straddle rules

Present Law

Straddle rules

In general

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[530] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

Positions in stock

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Although the straddle rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules generally do not apply if the option is a "qualified covered call option" written by the taxpayer.[531] 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.

---

[530] Sec. 1092.

[531] However, if the option written by the taxpayer is a qualified covered call option that is in-the-money, then (1) any loss with respect to such option is treated as long-term capital loss if, at the time such loss is realized, gain on the sale or exchange of the offsetting stock held by the taxpayer would be treated as long-term capital gain, and (2) the holding period of such stock does not include any period during which the taxpayer is the grantor of the option (sec. 1092(f)).

The stock exception from the straddle rules has been largely curtailed by statutory amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[532]

Unbalanced straddles

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[533] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45 per share, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[534] 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.[535] 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:

---

[532] Prop. Treas. Reg. sec. 1.1092(d)-2(c).

[533] Sec. 1092(c)(2)(B).

[534] Priv. Ltr. Rul. 199925044 (Feb. 3, 1999).

[535] 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.

> 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].

Holding period for dividends-received deduction

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends-received deduction for dividends received on that instrument.[536] The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day holding period for certain dividends on preferred stock).[537] The holding period must be satisfied for each dividend over a period that is immediately before and immediately after the taxpayer becomes entitled to receive the dividend. The 46- or 91-day holding period generally does not include any time during which the shareholder is protected (other than by writing a qualified covered call) from the risk of loss that is otherwise inherent in the ownership of any equity interest.[538]

Description of Proposal

Straddle rules

The proposal modifies the straddle rules in three respects: (1) permits taxpayers to identify offsetting positions of a straddle; (2) provides a special rule to clarify the present-law treatment of certain physically settled positions of a straddle; and (3) repeals the stock exception from the straddle rules.

Identified straddles

Under the proposal, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a

[536] Sec. 243. The amount of the deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns 20 percent or more of the stock, the deduction is increased to 80 percent. If the recipient owns 80 percent or more of the stock, the deduction is further increased to 100 percent for qualifying dividends.

[537] Sec. 246(c).

[538] Sec. 246(c)(4).

straddle, including an unbalanced straddle.[539] 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.[540] 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 proposal provides the Secretary authority to issue regulations that would specify (1) the proper methods for clearly identifying a straddle as an identified straddle (and identifying positions as positions in an identified straddle), (2) the application of the identified straddle rules for a taxpayer that fails to properly identify the positions of an identified straddle,[541] and (3) provide an ordering rule for dispositions of less than an entire position that is part of an identified straddle.

Physically settled straddle positions

The proposal 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 proposal clarifies that the present-law straddle loss deferral rules treat as a two-step transaction the physical settlement of a straddle position that, if terminated, would result in the realization of a loss. With respect to the physical settlement of such a position, the taxpayer is treated as having terminated the position for its fair market value immediately before the settlement. The taxpayer then is treated as having sold at fair market value the property used to physically settle the position.

---

[539] 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.

[540] 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.

[541] For example, although the proposal 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.

Stock exception repeal

The proposal also eliminates the exception from the straddle rules for stock (other than the exception relating to qualified covered call options). Thus, offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle.[542]

Dividends-received deduction holding period

The proposal also modifies the required 46- or 91-day holding period for the dividends-received deduction by providing that the holding period does not include any time during which the shareholder is protected from the risk of loss otherwise inherent in the ownership of any equity interest if the shareholder obtains such protection by writing an in-the-money call option on the dividend-paying stock.

Effective Date

The proposal is effective for positions established on or after the date of enactment that substantially diminish the risk of loss from holding offsetting positions (regardless of when such offsetting position was established).

Prior Action

Same as House bill.

9. Add vaccines against Hepatitis A to the list of taxable vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[543] 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.

---

[542] It is intended that Treasury regulations defining substantially similar or related property for this purpose will continue to apply subsequent to repeal of the stock exception and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock. *See* Prop. Treas. Reg. sec. 1.1092(d)-2(b). However, the general straddles rules regarding substantial diminution in risk of loss will continue to apply to stock of corporations formed or availed of to take positions in personal property that offset positions taken by the shareholder.

[543] sec. 4131

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal adds any vaccine against hepatitis A to the list of taxable vaccines.

Effective Date

The proposal is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

Prior Action

Same as House bill and modification of Senate amendment.

10. Add vaccines against influenza to the list of taxable vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[544] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal adds any trivalent vaccine against influenza to the list of taxable vaccines.

[544] sec. 4131

Effective Date

The proposal is effective for vaccines sold or used beginning on the later of the first day of the first month beginning more than four weeks after the date of enactment or the date on which the Secretary of Health and Human Services lists any such vaccine for purpose of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

Prior Action

Same as House bill and Senate amendment.

11. Extension of IRS user fees

Present Law

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[545] These user fees are authorized by statute through December 31, 2004.

Description of Proposal

The proposal extends the statutory authorization for these user fees through September 30, 2014.

Effective date.–Requests made after the date of enactment.

Prior Action

Same as House bill and same as Senate except different effective date.

12. Extension of customs user fees

Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 108-121 which extended authorization for the collection of these fees through March 1, 2005.[546]

---

[545] Section 7528.

[546] Sec. 201; 117 Stat. 1335.

Explanation of Proposal

The proposal extends the passenger and conveyance processing fees and the merchandise processing fees authorized under COBRA through September 30, 2014. For fiscal years after September 30, 2005, the Secretary is to charge fees in amounts that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The proposal also includes a Sense of the Congress that the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the COBRA have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The Sense of Congress also states that the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

The proposal further provides that the Secretary shall conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on what fees should be eliminated, what the rate of fees retains should be, and any other recommendations with respect to the fees that the Secretary considers appropriate.

Effective Date

The proposals are effective upon the date of enactment.

Prior Action

Same as House bill and modifies Senate amendment.

13. Prohibition on nonrecognition of gain through complete liquidation of holding company

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty

reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

Description of Proposal

The proposal treats as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

Effective Date

The proposal is effective for distributions occurring on or after the date of enactment.

Prior Action

Same as Senate amendment.

14. Effectively connected income to include certain foreign source income

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[547] 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

[547] Sections 871(b) and 882.

reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[548] 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.[549] 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.[550] 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.[551]

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.[552] 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.[553] 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.[554] The third category consists of income, gain, deduction, or loss derived from the sale or

[548] Section 864(c).

[549] Section 864(c)(4).

[550] Section 864(c)(4)(B).

[551] Section 864(c)(5).

[552] Section 864(c)(4)(B)(i).

[553] Section 864(c)(4)(B)(ii).

[554] Section 864(c)(4)(D)(i).

exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business.[555] 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.[556] 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.[557] 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.[558] 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.[559]

Description of Proposal

Under the proposal, each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents are treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States,

---

[555] Section 864(c)(4)(B)(iii).

[556] Sections 861 through 865.

[557] See Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982).

[558] Treas. Reg. sec. 1.864-5(b)(2)(ii).

[559] Treas. Reg. sec. 1.863-7(b)(3).

or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Effective Date

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

Prior Action

Same as Senate amendment.

15. Recapture of overall foreign losses on sale of controlled foreign corporation stock

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits generally is limited to 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.[560] 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.[561] 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.[562] 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.[563] In this regard, dispositions of trade or business property used predominantly outside the United States are treated as resulting in the recognition of foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market

---

[560] Section 904(a).

[561] Section 904(f).

[562] Section 904(f)(1).

[563] Section 904(f)(3).

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.[564]

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).[565] 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.

Description of Proposal

Under the proposal, the special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets applies to the disposition of stock in a controlled foreign corporation controlled by the taxpayer. Thus, a disposition of controlled foreign corporation stock by a controlling shareholder results in the recognition of foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income is resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Although the proposal generally extends to all dispositions of such stock, regardless of whether gain or loss is recognized on the transfer, exceptions are made for certain internal

---

[564] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Section 367(a)(3)(C).

[565] Section 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

restructurings. Contributions to corporations or partnerships under sections 351 and 721, respectively, and certain stock and asset reorganizations do not trigger recapture of overall foreign losses, provided that the transferor's underlying indirect interest in the disposed controlled foreign corporation does not change. In addition, a disposition of controlled foreign corporation stock in a transaction in which the taxpayer or a member of its consolidated group acquires the assets of the controlled foreign corporation in a liquidation under section 332 or a reorganization does not trigger recapture. However, any gain recognized in connection with a transaction meeting any of these exceptions, such as boot, triggers recapture of overall foreign losses to the extent of such gain.

Effective Date

The proposal applies to dispositions after the date of enactment.

Prior Action

Modification of Senate amendment.

16. Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest

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.[566] 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").[567]

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

[566] Sec. 108(e)(8).

[567] *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.

corporations.[568] 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 exception. It also is unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[569]

Description of Proposal

The proposal provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The proposal applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the proposal is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the proposal, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Effective Date

This proposal is effective for cancellations of indebtedness occurring on or after the date of enactment.

Prior Action

Same as Senate amendment.

---

[568] Sec. 108(a).

[569] *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.

17. Denial of installment sale treatment for all readily tradable debt

Present Law

Under present law, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[570] 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.[571]

No similar provision under present law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

Description of Proposal

The proposal denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable under present-law rules, regardless of the nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

Effective Date

The proposal is effective for sales occurring on or after date of enactment.

Prior Action

Same as Senate amendment.

18. Modify treatment of transfers to creditors in divisive reorganizations

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a subsidiary tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the corporation ("controlled') that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That

---

[570] Sec. 453.

[571] Sec. 453(f)(3). Instead, the receipt of such indebtedness is treated as a receipt of payment.

section also applies to certain transactions that do not involve a distribution under section 355 and that are considered 'acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

Description of Proposal

The proposal limits the amount of money or other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the proposal provides that acquisitive reorganizations under section 368(a)(1)(D) are no longer subject to the liabilities assumption rules of section 357(c).

Effective Date

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

Prior Action

Same as Senate amendment.

19. Clarify definition of nonqualified preferred stock

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.

Description of Proposal

The proposal clarifies the definition of nonqualified preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

As one example, instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred stockholders. As another example, stock that entitles the holder to a dividend that is the greater of 7 percent or the dividends common shareholders receive does not avoid being preferred stock if the common shareholders are not expected to receive dividends greater than 7 percent.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective Date

The proposal is effective for transactions after May 14, 2003.

Prior Action

Same as Senate amendment.

20. Modify definition of controlled group of corporations

Present Law

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

Table 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.

The component members of a controlled group of corporations are limited to one amount in each of the taxable income brackets shown above.[572] 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.[573]

Description of Proposal

Under the proposal, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50 percent of 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.

The proposal applies only for purposes of section 1561, currently relating to corporate tax brackets, the accumulated earnings credit, and the minimum tax. The proposal 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.[574]

---

[572] Component members are also limited to one alternative minimum tax exemption and one accumulated earnings credit.

[573] Sec. 1563(a)(2). The Supreme Court held in *United States v. Vogel Fertilizer*, 455 US 16 (1982), that Treas. Reg. Sec. 1.1563-1(a)(3) was invalid insofar as it would require an individual's stock to be taken into account, for purposes of the 80-percent brother-sister corporation ownership test, where that individual did not own stock in each of the corporations in the asserted controlled group. In that case, one corporation was owned 77.49 percent by one shareholder and 22.51 by an unrelated shareholder. The 77.49 percent shareholder of that first corporation also owned 87.5 percent of the voting stock and more than 90 percent of the value of the stock of a second corporation. The Supreme Court held the corporations were not a controlled group, even though they would have been one had the Treasury Regulations been considered valid in their application to the case.

[574] As one example, the proposal does not change the present law standards relating to deferred compensation, contained in subchapter D of the Code, that refer to section 1563.

Effective Date

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

Prior Action

Same as Senate amendment.

21. Establish specific class lives for utility grading costs

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[575] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

Description of Proposal

The proposal would assign 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

[575] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective Date

The proposal would be effective for property placed in service after the date of enactment.

Prior Action

Same as Senate amendment.

22. Provide consistent amortization period for intangibles

Present Law

At the election of the taxpayer, start-up expenditures[576] and organizational expenditures[577] 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[578] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

Description of Provision

---

[576] Sec. 195

[577] Secs. 248 and 709.

[578] Treas. Reg. sec. 1.195-1.

The provision would modify the treatment of start-up and organizational expenditures. A taxpayer would be allowed to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective Date

The proposal would be 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.

Prior Action

Same as Senate amendment.

23. Freeze of provision regarding suspension of interest where Secretary fails to contact taxpayer

Present Law

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest after 1 year after the filing of the tax return[579] if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period.[580] With respect to taxable years beginning before January 1, 2004, the one-year period is increased to 18 months. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

[579] If the return is filed before the due date, for this purpose it is considered to have been filed on the due date.

[580] Sec. 6404(g). This provision was added to the Code by sec. 3305 of the IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, July 22,1998).

Description of Proposal

The provision makes the 18-month rule the permanent rule. The provision also adds gross misstatements[581] and listed and reportable transactions to the list of provisions to which the suspension of interest rules do not apply.

Effective Date

Taxable years beginning after December 31, 2003[582], except the addition of listed and reportable transactions applies to interest accruing after October 3, 2004.

Prior Action

Modification of Senate amendment.

24. Increase in withholding from supplemental wage payments in excess of $1 million

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate,[583] based on the third lowest income tax rate under the Code (25 percent for 2005).[584]

Description of Proposal

Under the proposal, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to

---

[581] This includes any substantial omission of items to which the six-year statute of limitations applies (sec. 6051(e), gross valuation misstatements (sec. 6662(h)), and similar provisions.

[582] It is intended that this provision apply retroactively to the period beginning January 1, 2004 and ending on the date of enactment. The due date for returns for the taxable period beginning January 1, 2004 is generally April 15, 2005; April 15, 2005 is therefore the date from which the 12-month period that must pass under present-law prior to the commencement of suspension is calculated. Consequently, suspension of interest would generally not begin until April 15, 2006. Accordingly, the provision has no actual retroactive effect.

[583] Sec. 13273 of the Revenue Reconciliation Act of 1993.

[584] Sec. 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

withholding at the highest income tax rate (35 percent for 2005), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) are not affected.

Effective Date

The proposal is effective with respect to payments made after December 31, 2004.

Prior Action

Same as Senate amendment except for effective date.

25. Capital gain treatment on sale of stock acquired from exercise of statutory stock options to comply with conflict of interest requirements

Present Law

Statutory stock options

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. Upon such exercise, an employer is allowed a corresponding compensation deduction. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[585]

If an employee disposes of stock acquired upon the exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within two years after the date the option is granted or one year after the date the option is exercised. The gain upon a disposition that occurs prior to the expiration of the applicable holding period(s) (a "disqualifying disposition") does not qualify for capital gains treatment. In the event of a disqualifying disposition, the income attributable to the disposition is treated by the employee as income received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Sale of property to comply with conflict of interest requirements

The Code provides special rules for recognizing gain on sales of property which are required in order to comply with certain conflict of interest requirements imposed by the Federal

[585] Sec. 421.

government.[586] Certain executive branch Federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

Description of Proposal

Under the proposal, an eligible person who, in order to comply with Federal conflict of interest requirements, is required to sell shares of stock acquired pursuant to the exercise of a statutory stock option is treated as satisfying the statutory holding period requirements, regardless of how long the stock was actually held. An eligible person generally includes an officer or employee of the executive branch of the Federal Government (and any spouse or minor or dependent children whose ownership in property is attributable to the officer or employee). Because the sale is not treated as a disqualifying disposition, the individual is afforded capital gain treatment on any resulting gains. Such gains are eligible for deferral treatment under section 1043.

The employer granting the option is not allowed a deduction upon the sale of the stock by the individual.

Effective Date

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

Prior Action

Same as Senate amendment.

26. Application of basis rules to nonresident aliens

Present Law

Distributions from retirement plans

Distributions from retirement plans are includible in gross income under the rules relating to annuities[587] and, thus, are generally includible in income, except to the extent the amount received represents investment in the contract (i.e., the participant's basis). The participant's basis includes amounts contributed by the participant on an after-tax basis, together with certain amounts contributed by the employer, minus the aggregate amount (if any) previously distributed

[586] Sec. 1043.

[587] Secs. 72 and 402.

to the extent that such amount was excludable from gross income. Amounts contributed by the employer are included in the calculation of the participant's basis only to the extent that such amounts were includible in the gross income of the participant, or to the extent that such amounts would have been excludable from the participant's gross income if they had been paid directly to the participant at the time they were contributed.[588]

Employer contributions to retirement plans and other payments for labor or personal services performed outside the United States by a nonresident alien generally are not treated as U.S. source income. Such contributions, therefore, generally would not be includible in the nonresident alien's gross income if they had been paid directly to the nonresident alien at the time they were contributed. Consequently, the amounts of such contributions generally are includible in the employee's basis and are not taxed by the United States if a distribution is made when the employee is a U.S. citizen or resident.[589]

Earnings on contributions are not included in basis unless previously includible in income. In general, in the case of a nonexempt trust, earnings are includible in income when distributed or made available.[590] In the case of highly compensated employees, the amount of the vested accrued benefit under the trust (other than the employee's investment in the contract) is generally required to be included in income annually (i.e., earnings are taxed as they accrue).[591]

Property transferred in connection with the performance of services

The Code contains rules governing the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, in general, an amount is includible in the gross income of the person performing the services (the "service provider") for the taxable year in which the property is first vested (i.e., transferable or not subject to a substantial risk of forfeiture).[592] The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. Basis in such property includes any amount that is included in income as a result of the transfer.[593]

---

[588] Sec. 72(f).

[589] Rev. Rul. 58-236, 1958-1 C.B. 37.

[590] Sec. 402(b)(2).

[591] Sec. 402(b)(4).

[592] Sec. 83(a).

[593] Treas. Reg. sec. 1.61-2(d)(i).

U.S. income tax treaties

Under the 1996 U.S. Model Income Tax Treaty ("U.S. Model") and some U.S. income tax treaties in force, retirement plan distributions beneficially owned by a resident of a treaty country in consideration for past employment generally are taxable only by the individual recipient's country of residence. Under the U.S. Model treaty and some U.S. income tax treaties, this exclusive residence-based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a retirement plan's earnings, subsequent distributions to that person while a resident of the United States would not be taxable in the United States to the extent the distributions were attributable to such previously taxed amounts.

Compensation of employees of foreign governments or international organizations

Under section 893, wages, fees, and salaries of any employee of a foreign government or international organization (including a consular or other officer or a nondiplomatic representative) received as compensation for official services to the foreign government or international organization generally are excluded from gross income when (1) the employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines (whether or not a citizen of the United States); (2) in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the United States in foreign countries; and (3) in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the United States performing similar services in such foreign country. The Secretary of State certifies the names of the foreign countries which grant an equivalent exclusion to employees of the United States performing services in those countries, and the character of those services.

The exclusion does not apply to employees of controlled commercial entities or employees of foreign governments whose services are primarily in connection with commercial activity (whether within or outside the United States) of the foreign government.

Description of Proposal

The proposal modifies the present-law rules under which certain contributions and earnings that have not been previously taxed are treated as basis. Under the proposal, employee or employer contributions are not included in basis if: (1) the employee was a nonresident alien at the time the services were performed with respect to which the contribution was made; (2) the contribution is with respect to compensation for labor or personal services from sources without the United States; and (3) the contribution was not subject to income tax (and would have been subject to income tax is paid as cash compensation when the services were rendered) under the laws of the United States or any foreign country.

Under the proposal, earnings on employer or employee contributions are not included in basis if: (1) the earnings are paid or accrued with respect to any employer or employee contributions which were made with respect to compensation for labor or personal services; (2) the employee was a nonresident alien at the time the earnings were paid or accrued; and (3) the

earnings were not subject to income tax under the laws of the United States or any foreign country. No inference is intended that under present law there is basis for earnings not previously subject to tax.

The proposal does not change the rules applicable to calculation of basis with respect to contributions or earnings while an employee is a U.S. resident. For example, suppose employer contributions were made to a retirement plan on behalf of an individual (E) while the individual was a nonresident alien. The contributions were not subject to income tax in the United States or a foreign country. Suppose the contributions are in a discriminatory nonexempt trust so that earnings on the trust would be taxable to E if E were a United States resident; however, because E is a nonresident alien, E is not subject to tax on the earnings. Suppose E then relocates to the United States and becomes a U.S. resident, during which time earnings on the trust are taxable under the rules requiring income inclusion of vested accrued amounts for highly compensated employees. E's basis does not include the employer contributions, nor any earnings paid or accrued while E was a nonresident alien. E's basis will include the earnings includible in gross income while E was a U.S. resident.

There is no inference that the proposal applies in any case to create tax jurisdiction with respect to wages, fees, and salaries otherwise exempt under section 893. Similarly, there is no inference that the proposal applies where contrary to an agreement of the United States that has been validly authorized by Congress (or in the case of a treaty, ratified by the Senate), and which provides an exemption for income.

Most U.S. tax treaties specifically address the taxation of pension distributions. The U.S. Model treaty provides for exclusive residence-based taxation of pension distributions to the extent such distributions were not previously included in taxable income in the other country. For treaty purposes, the United States treats any amount that has increased the recipient's basis (as defined in section 72) as having been previously included in taxable income. The following example illustrates how the proposal could affect the amount of a distribution that may be taxed by the United States pursuant to a tax treaty.

Assume the following facts. A, a nonresident alien individual, performs services outside the United States. A's employer makes contributions on behalf of A to a pension plan established in A's country of residence, Z. For U.S. tax purposes, no portion of the contributions or earnings are included in A's gross income (and would not be included in income if paid as cash compensation when the services were performed) because such amounts relate to services performed without the United States.[594] Later in time, A retires and becomes a resident alien of the United States.

Under the proposal, the employer contributions to the pension plan would not be taken into account in determining A's basis if A was not subject to income tax on the contributions by a foreign country and the contributions would have been subject to tax by a foreign country if the contributions had been paid to A as cash compensation when the services were performed. Thus, in those circumstances, A would be subject to U.S. tax on the distribution of all of the

[594] Sec. 872.

contributions, as such distributions are made. Earnings that accrued while A was a nonresident alien would be subject to the conference agreement. Earnings that accrued while A was a resident alien of the United States would be subject to present-law rules. This result is consistent with the treatment of pension distributions under the U.S. Model treaty.

Even though A is a resident alien under U.S. statutory rules, if A is a resident of country Y, with which the United States has an income tax treaty (including a pension provision identical to the U.S. Model) and A qualifies for benefits as a resident of Y under the U.S.-Y treaty, A would be subject to U.S. tax on the distributions only to the extent the amounts were not previously included in A's taxable income in country Y. Thus, if Y had taxed A on the employer contributions or the earnings of the plan, distributions attributable to these previously taxed amounts would not be subject to U.S. income tax pursuant to the U.S.-Y tax treaty. On the other hand, if Z rather than Y had taxed A on the employer contributions or earnings of the plan, the pension provision in the U.S.-Y treaty would not apply.

The proposal authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of the proposal, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances. For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the "subject to income tax" requirement.

The proposal also changes the rules for determining basis in property received in connection for the performance of services in the case of an individual who was a nonresident alien at the time of the performance of services, if the property is treated as income from sources outside the United States. In that case, the individual's basis in the property does not include any amount that was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were performed) under the laws of the United States or any foreign country.

Effective Date

The proposal is effective for distributions occurring on or after the date of enactment.

Prior Action

Modification of Senate amendment.

27. Deduction for personal use of company aircraft and other entertainment expenses

Present Law

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.[595] The Code includes a number of exceptions to the general rule disallowing deductions

[595] Sec. 274(a).

of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[596] The deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or award.[597] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[598] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[599] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[600]

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation has been interpreted as not limiting the company's deduction for operation of the aircraft to the amount of compensation reportable to its employees,[601] which can result in a deduction multiple times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

Description of Proposal

Under the proposal, in the case of specified individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in

---

[596] Sec. 274(e)(2).

[597] Sec. 274(e)(9).

[598] Treas. Reg. sec. 1.61-21.

[599] Treas. Reg. sec. 1.61-21(g).

[600] Treas. Reg. sec. 1.61-21(b)(6).

[601] *Sutherland Lumber-Southwest, Inc. v. Comm.*, 114 T.C. 197 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (Feb. 11, 2002).

income apply only to the extent of the amount of expenses treated as compensation or includible in income. Specified individuals are individuals who, with respect to an employer or other service recipient, are, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)),[602] directors, and 10-percent-or-greater owners of private and publicly-held companies. For specified individuals, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income for the individual. For example, a company's deduction attributable to aircraft operating costs for a director's vacation use of a company aircraft is limited to the amount reported as compensation to the individual. As under present law, the amount of the deduction cannot exceed the actual cost.

The proposal is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Commissioner* with respect to specified individuals. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Effective Date

The proposal is effective for expenses incurred after the date of enactment.

Prior Action

Modification of Senate amendment.

28. Residence and source rules relating to United States possessions

Present Law

In general

Generally, U.S. citizens are subject to U.S. income taxation on their worldwide income. Thus, all income earned by U.S. citizens is subject to U.S. income tax, regardless of its source.

The U.S. income taxation of alien individuals varies depending on whether they are resident or non-resident aliens. A resident alien is generally taxed in the same manner as a U.S.

---

[602] 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.

citizen.[603] In contrast, a nonresident alien is generally subject to U.S. tax only on certain gross U.S. source income at a flat 30 percent rate (unless such rate is eliminated or reduced by treaty) and on net income that is effectively connected to a U.S. trade or business at the graduated rates applicable to U.S. citizens and residents under section 1.

An alien is considered a resident of the United States if the individual: (1) has entered the United States as a lawful permanent resident and is such a resident at any time during the calendar year, (2) is present in the United States for a substantial period of time (the so-called "substantial presence test"), or (3) makes an election to be treated as a resident of the United States (sec. 7701(b)). An alien who does not meet the definition of a "resident alien" is considered to be a non-resident alien for U.S. income tax purposes.

Under the substantial presence test, an alien individual is generally treated as a resident alien if he or she is present in the United States for 31 days during the taxable year and the sum of the number of days on which such individual was present in the United States (when multiplied by the applicable multiplier) during the current year and the preceding two calendar years equals or exceeds 183 days. The applicable multiplier for: the current year is one, for the first preceding year is 1/3, and for the second preceding year is 1/6.

An alien individual who meets the above test may nevertheless be a nonresident if he or she (1) is present in the United States for fewer than 183 days during the current year; (2) has a tax home in a foreign country during the year; and (3) has a closer connection to that country than to the United States.

For purposes of the substantial presence test, the United States includes the states and the District of Columbia, but does not include the U.S. possessions. An individual is present in the United States for a particular day if he or she is physically present in the United States during any time during such day. However, in certain circumstances an individual's presence in the United States is ignored, including presence in the United States as a result of certain medical emergencies

U.S. income taxation of residents of U.S. possessions

Special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of certain U.S. possessions, including Puerto Rico, Virgins Islands, Guam, Northern Mariana Islands and American Samoa.

The Code does not indicate how it is determined if a person is a bona fide resident of a U.S. possession. Generally, the regulations provide that a bona fide resident of a U.S. possession (regardless of whether the individual is a U.S. citizen or alien) is determined using the principles of a subjective, facts-and-circumstances test set forth in the regulations under section 871 (the "section 871 test"). Prior to 1984 and the adoption of current section 7701(b), the section 871 test was used to determine whether an alien individual was a resident of the United States. Under these rules, an individual is generally a resident of the United States if (1) she is actually

[603] Section 7701(a)(30) defines a citizen or resident of the United States as "U.S. persons."

present in the United States, and (2) she is not a mere transient or sojourner.[604] Whether individuals are transients is determined by their intentions with regard to the length and nature of their stay. Courts have looked at a number of factors in applying the test. However, the regulations provide that section 7701(b) (discussed above) provides the basis for determining whether an alien individual is a resident of a United States possession with a mirror income tax code.[605]

Information reporting

Section 7654(e) provides that Treasury may require information reporting with respect to individuals that may take advantage of certain special U.S. income tax rules because they are residents of certain U.S. possessions. Section 6688 provides that an individual may be subject to a $100 penalty if the individual fails furnish the information required by regulations issued pursuant to section 7654(e).

Description of Proposal

Except as provided in regulations, for purposes of subpart D (including section 935 as in effect prior to the effective date of its repeal), section 865(g)(3), section 876, section 881(b), paragraphs (2) and (3) of section 901(b), section 957(c), section 3401(a)(8)(C), and section 7654(a), the term "bona fide resident" means a person who meets a two-part test with respect to Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands, as the case may be for the taxable year. First, the taxpayer must be present in the U.S. possession for 183 days each taxable year. Second, an individual must (i) have a tax home outside such possession during the taxable year and (ii) have a closer connection to the United States or a foreign country during such year. The determination as to whether a person is present for any day shall be made under the principles of section 7701(b).

The proposal also provides that except as provided in regulations, for all purpose of the Code, (1) the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source; and (2) the principles for determining whether income is effectively connected to a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to a possession trade or business. However, any income treated as U.S. source income or as effectively connected with a U.S. trade or business is not be treated as income from within any U.S. possession or as effectively connected with a trade or business within any such possession.

The proposal rationalizes the current rules under sections 931-935 providing certain residents of U.S. possessions an exemption from U.S. tax. Under the proposal, a U.S. citizen

---

[604] Treas. Reg. sec. 1.871-2(b).

[605] A U.S. possession with a mirror income tax code is "a United States possession . . . that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term "United States" where appropriate) to those in the United States." Treas. Reg. sec. 7701(b)-1(d)(1).

must be a resident in a U.S. possession during the entire taxable year to qualify for an exemption from U.S. tax under section 931-935, regardless of the possession at issue.

The proposal provides that a taxpayer must file a notice in the first taxable year they are claiming bona fide residency in a U.S. possession. If during any of the individual's taxable years ending before the first taxable year ending after the date of enactment, the individual must file a notice that he or she is claiming bona fide residence in the current taxable year. The proposal imposes a penalty of $1000 for the failure to file such notice or to comply with the any filing required by regulation under 7654(e).

Effective Date

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

Prior Action

Modification of Senate amendment.

29. Dispositions of transmission property to implement Federal Energy Regulatory Commission restructuring policy

Present Law

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

Description of Proposal

The proposal would permit a taxpayer to elect to recognize gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[606] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain shall be recognized to the extent of such excess in the year of the qualifying electric transmission transaction. Any remaining realized gain is recognized ratably over the eight-year period.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider[607] approved by the FERC; (2) a person (i) who the FERC determines under

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

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

section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

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

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

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

An electing taxpayer is required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in the manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years.[608] In addition, an electing taxpayer is required to attach a statement that identifies the reinvestment property in the manner as the Secretary shall prescribe.

Effective Date

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

Prior Action

Modification of Senate amendment.

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