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

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

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION

October 1, 2003
JCX-85-03

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on October 1, 2003, of S. 1637, the "Jumpstart Our Business Strength (JOBS) Act," together with additional provisions not included in S. 1637 as introduced. A description of the Chairman's mark of the JOBS Act and the additional provisions was published on September 26, 2003.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Modification. This document is divided into three parts. The first part describes modification to proposals included in the Chairman's mark. The second part describes new proposals that were not included in the Chairman's mark. The third part includes new revenue offset proposals, not included in the Chairman's mark.

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

[2] This document may be cited as follows: Joint Committee on Taxation, *Modification to the Chairman's Mark on the "Jumpstart Our Business Strength (JOBS) Act"* (JCX-85-03), October 1, 2003.

I. MODIFICATIONS TO PROVISIONS IN THE CHAIRMAN'S MARK

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

In general

The modification limits the deduction for a taxable year to 50 percent of the wages paid by the taxpayer during such taxable year with respect to domestic production activities.

The modification also extends the allowable deduction to partnerships and sole proprietorships. The term "sole proprietorship" is defined to include any individual taxpayer for any taxable year for which the taxpayer reports gross profit on Schedule C (Profit or Loss From Business) or Schedule F (Profit or Loss From Farming) of Form 1040. With respect to partnerships, the modification includes certain anti-abuse rules and reporting requirements. The anti-abuse rules include restrictions on the special allocation of the deduction to partners by requiring that a partner's distributive share of the deduction be consistent with such partner's distributive share of qualified production activities income. The reporting requirements provide that the IRS will require additional information concerning eligibility for the deduction to be reported on relevant tax forms filed by the taxpayer. For example, the modification requires the tax matters partner for the partnership to certify on the partnership tax return that the partnership is eligible for the full amount of the deduction claimed on the return. The ability of partners to claim their distributive share of the deduction is subject to the passive activity loss limitations of section 469 of the Code.

The modification also modifies the special rule for partnerships with corporate partners to conform to the treatment of partnerships under the modification.

Qualified production activities income

The modification modifies the reduction in qualified production activities income by virtue of the domestic/worldwide fraction. For taxable years beginning before 2010, the reduction in qualified production activities income by virtue of the domestic/worldwide fraction is 100 percent. For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is 75, 50, and 25 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

Qualifying production property

The modification eliminates the exclusion of unprocessed timber which is softwood from the definition of "qualifying production property". Thus, the term "qualifying production property" includes such property under the modification.

The modification also eliminates the exclusion of primary products of oil or gas from the definition of "qualified production property". The modification is limited to primary products that are produced (or processed) at an oil or gas refinery. In the case of crude oil, the modification does not apply to any taxpayer that directly or indirectly sells oil or natural gas at retail, and does not apply to any taxpayer or a related person for a taxable year if on any day during such taxable year, the crude oil refinery runs of the taxpayer and such related person exceed 50,000 barrels.

The modification also clarifies that, for purposes of the definition of "qualified production property," property described in section 168(f)(3) or (4) of the Code includes underlying copyrights and trademarks.[3]

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[3] Property described in section 168(f)(3) or (4) is treated as "qualified production property" if more than 50 percent of the development or production costs of such property are incurred by the taxpayer within the United States. For this purpose, property that is acquired by the taxpayer after development or production has commenced, but before such property generates substantial gross receipts, shall be treated as developed or produced by the taxpayer, provided the property would satisfy the requirements of the modification if such property had been developed or produced by the taxpayer.

B. Twenty-Year Foreign Tax Credit Carryforward

The modification makes the extended carryforward period effective for excess foreign taxes that may be carried to any taxable years ending after the date of enactment of the proposal. The modification also replaces the present-law two-year carryback period with a one-year carryback period for credits arising in taxable years beginning after the date of enactment of the proposal.

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

The modification clarifies that the look-through rule applies to dividends that a controlled foreign corporation receives from a 10/50 company and then distributes to a U.S. shareholder.

D. Interest Expense Allocation Rules

The modification makes the proposal effective for taxable years beginning after December 31, 2008. The general election under the proposal must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. The financial institution group election must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation.

E. Tax Treatment of Inversion Transactions

The modification removes the “pre-filing procedure” set forth in the proposal in the Chairman’s mark. In its place, the modification enhances the accuracy-related penalties as applied to taxpayers that would have been subject to this procedure. Specifically, the 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to such taxpayers. In addition, the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers.

F. Disallowance of Certain Partnership Loss Transfers

The provision relating to the disallowance of certain partnership loss transfers is deleted from the Chairman's mark.

II. ADDITIONAL PROVISIONS

The modification adds the following additional provisions.

A. International Tax

1. Subpart F exception for active aircraft and vessel leasing income

Present Law

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

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

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

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

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

Description of Proposal

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

Effective Date

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

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

Present Law

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

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

Description of Proposal

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

Effective Date

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

3. Look-through treatment under subpart F for sales of partnership interests

Present Law

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

Description of Proposal

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

Effective Date

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

4. Election not to use average exchange rate for foreign tax paid other than in functional currency

Present Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.[4] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[5]

Description of Proposal

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the proposal provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional

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

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

currency.[6] Any election under the proposal applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The proposal authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

Effective Date

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

5. Foreign tax credit treatment of "base difference" items

Present Law

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

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

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[8] In cases in which foreign law imposes

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

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

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

tax on an item of income that does not constitute income under U.S. tax principles (a "base difference" item), the tax is treated as imposed on income in the general limitation category.[9]

Description of Proposal

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

Effective Date

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

6. Modification of exceptions under subpart F for active financing income

Present Law

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

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

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

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[10]

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

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

Description of Proposal

The proposal modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the proposal provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is

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

performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country.

Effective Date

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

7. United States property not to include certain assets of controlled foreign corporation

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year (sec. 951(a)(1)(B)).

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

Description of Proposal

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

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

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

Effective Date

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

8. Provide equal treatment for interest paid by foreign partnerships and foreign corporations

Present Law

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[11] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[12] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[13]

Description of Proposal

The proposal treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The proposal applies only to foreign partnerships that are principally owned by foreign persons. For this purpose, a foreign partnership is principally owned by foreign persons if non-U.S. residents or foreign corporations in the aggregate own more than 80 percent of the capital and profits interests in the partnership.

Effective Date

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

9. Foreign tax credit treatment of deemed payments under section 367(d)

Present Law

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible

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

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

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

property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[14]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[15] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[16]

Description of Proposal

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

Effective Date

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

10. Modify FIRPTA rules for real estate investment trusts

Present Law

A real estate investment trust ("REIT") is a U.S. entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible

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

[15] Sec. 904(d).

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

by the REIT, and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income to its investors before the end of its taxable year.

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

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

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions.

Description of Proposal

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

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

Effective Date

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

11. Temporary rate reduction for certain dividends received from controlled foreign corporations

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[17] and the passive foreign investment company rules.[18] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[19]

Description of Proposal

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

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[20] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

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

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[17] Secs. 951-964.

[18] Secs. 1291-1298.

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

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

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

The proposal disallows 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and removes 85 percent of the underlying income from the taxpayer's foreign tax credit limitation fraction under section 904.

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

Effective Date

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

12. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals

Present Law

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

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[21] event taking place within the United States, the

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

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

Description of Proposal

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

Effective Date

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

13. Require commerce department report on adverse decisions of the world trade organization

Present Law

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

Description of Proposal

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

Effective Date

The proposal is effective on the date of enactment.

14. Consultative role for Senate Committee on Finance in connection with the review of proposed tax treaties

Present Law

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

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

Description of Proposal

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

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

Effective Date

The proposal would be effective on the date of enactment.

15. Study of impact of international tax law on taxpayers other than large corporations

Present Law

The United States employs a "worldwide" tax system, under which U.S. persons (including domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including foreign corporations) are subject to U.S. tax only on certain income U.S. source income and income that has a sufficient nexus to the United States. The United States generally provides a credit to U.S. persons for foreign income taxes paid or accrued.[22] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[23]

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

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

Description of Proposal

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

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[22] Sec. 901.

[23] Secs. 901, 904.

including any recommendations for legislative or administrative changes to reduce the compliance burden on taxpayers other than large corporations and for such other purposes as the Secretary determines appropriate.

Effective Date

This proposal is effective after date of enactment.

B. Domestic Manufacturing and Business Provisions

1. Expansion of qualified small-issue bond program

Present Law

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

Property and businesses eligible for this financing are specified. For example, only depreciable property (and related real property) used in the production of tangible personal property is eligible for financing as a manufacturing facility. Storage and distribution of products generally is not treated as production under this provision. Agricultural land and equipment may only be financed for first-time farmers, defined as individuals who have not at any prior time owned farmland in excess of (1) 15 percent of the median size of a farm in the same county or (2) $125,000 in value.

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

Description of Proposal

The proposal increases the maximum allowable amount of total capital expenditures by a business in the same municipality or county during the six-year period from $10 million to $20 million. However, the proposal does not change the present-law requirement that no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. As under present-law, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the total capital expenditures limit.

Effective Date

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

2. Expensing of investment in broadband equipment

Present Law

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

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

Description of Proposal

The proposal provides that expenses incurred by the taxpayer for qualified broadband expenditures with respect to qualified equipment placed in service prior to January 1, 2005 may be deducted in full in the year in which the equipment is placed in service.

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

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

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

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

Effective Date

The proposal is effective for property placed in service after December 31, 2003.

3. Exemption for natural aging process from interest capitalization

Present Law

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

Special rules apply for the allocation of interest expense to property produced by the taxpayer.[24] In general, interest paid or incurred during the production period of certain types of

[24] Sec. 263A(f).

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

Description of Proposal

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

Effective Date

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

4. Section 355 "active business test" applied to chains of affiliated corporations

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[25] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[26]

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[25] Sec. 355(b). If the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[26] Sec. 355(b)(2)(A).

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes had been that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[27] However, the IRS recently removed this requirement in the context of a new revenue procedure.[28] If the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[29]

Description of Proposal

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

Effective Date

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

The proposal also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[30]

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

[28] Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

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

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

5. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness

Present Law

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

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.[31] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property. An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is not treated as the creation of a new indebtedness.

Description of Proposal

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

Effective Date

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

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

6. Modified taxation of imported archery products

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more.[32] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[33] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[34]

Description of Proposal

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more. The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the proposal. The proposal provides that the 12-percent excise tax on arrows will not apply if the arrow contains an arrow shaft upon which the tax imposed on arrow components has been paid. Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

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

7. Modify cooperative marketing rules to include value added processing involving animals

Present Law

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

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

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

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

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

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

Description of Proposal

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

Effective Date

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

8. Extend declaratory judgment procedures to farmers' cooperative organizations

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[35] In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

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

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

Description of Proposal

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

Effective Date

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

9. Repeal personal holding company tax

Present Law

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

Table 1.–Marginal Federal Corporate Income Tax Rates

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

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

When a corporation distributes its after-tax earnings to individual shareholders as dividends, a tax is imposed on the shareholders at rates up to 15 percent.[36] If a corporation receives a dividend from another corporation, the recipient corporation is entitled to a dividends-received deduction that excludes a significant part of the dividend from the recipient's income. The percentage of a dividend received that is deducted varies from 70 percent to 100 percent, depending on the level of ownership of the recipient corporation in the distributing corporation.[37]

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

[37] If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. If the recipient corporation owns less than 80

Thus, with a 70 percent dividends received deduction, the tax rate imposed on a dividend received by a corporation in the 35-percent tax bracket is 10.5 percent.[38] For corporations at lower rate brackets, the tax rates on these dividends are lower.

In addition to the regular corporate income tax, a corporate level penalty tax, "the "personal holding company tax" is currently imposed at 15 percent [39] on certain corporate earnings of personal holding companies that are not distributed to shareholders. The personal holding company tax was originally enacted to prevent so-called "incorporated pocketbooks" that could be formed by individuals to hold assets that could have been held directly by the individuals, such as passive investment assets, and retain the income at corporate rates that were then significantly lower than individual tax rates.

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

A corporation that otherwise would be subject to personal holding company tax can distribute, or can agree to be deemed to have distributed, its modified taxable income and avoid the tax. A corporation may make such an actual dividend distribution during its taxable year or until the 15th day of the third month following the close of its taxable year. In addition, if an election is filed with its return for the year, its shareholders may agree to include a deemed amount in their income as if a dividend had been paid ("consent dividend"). A corporation may also make a "deficiency dividend" distribution within 90 days following a determination by the IRS or a court that personal holding company tax liability is due. That distribution can eliminate the personal holding company tax itself, though interest (and penalties, if any) with respect to such tax would still be owed to the IRS.[40]

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

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

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

[40] Section 547.

Corporations that are not personal holding companies may be subject the accumulated earnings tax. The tax is imposed at the same rate as the personal holding company tax. Unlike the personal holding company tax definition, which is very specific regarding the percentages of ownership and of various types of income that can trigger the tax if earnings are not distributed, the situations in which the accumulated earnings tax may apply are determined on a more subjective basis. The tax is imposed on a corporation that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."[41] If earnings (from any type of income) "are permitted to accumulate beyond the reasonable needs of the business", the prohibited purpose is presumed to exist "unless the corporation by the preponderance of the evidence shall prove to the contrary".[42]

A corporation that is a "mere holding or investment company" is presumed to be accumulating earnings for the purpose of avoiding distributions to shareholders.[43] Unlike the personal holding company rules, there are no specific rules for determining what level of active income would avoid this definition.

A safe harbor de-minimis exemption, the "accumulated earnings credit", generally permits a corporation (including a mere holding or investment company) to accumulate a total of $250,000 of earnings without becoming subject to any risk of the tax being imposed.[44]

Description of Proposal

The proposal would repeal the personal holding company tax for the period of time until the 15 percent rate on dividends received by individuals is scheduled to expire.

Effective Date

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

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

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[41] Section 532(a).

[42] Section 533(a).

[43] Section 533(b).

[44] Section 535(c). The accumulated earnings credit is the amount, if any, by which the credit amount exceeds the total earnings and profits already accumulated as of the close of the prior taxable year. Certain service companies have a lower credit amount of $150,000. Section 535(c)(2)(B).

C. Manufacturing Relating to Films

1. Special rules for certain film and television production

Present Law

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

Description of Proposal

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

The proposal limits the amount of production expenditures that may be expensed to $15 million for each qualifying production. An additional $5 million of production expenditures may be expensed (up to $20 million in total) if the production expenditures occur in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. Expenditures in excess of the $15 million (or $20 million in distressed areas) are required to be recovered over a three-year period using the straight-line method.

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

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

Effective Date

The proposal is effective for qualifying productions started after the date of enactment.

2. Modification of application of income forecast method of depreciation

Present Law

Depreciation

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

Income forecast method of depreciation

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

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

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

Description of Proposal

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

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

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

Effective Date

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

D. Manufacturing Relating to Timber

1. Expensing of reforestation expenses

Present Law

Amortization of reforestation costs (sec. 194)

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

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

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

Reforestation tax credit (sec. 48(b))

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

Description of Proposal

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

The proposal replaces both the amortization and credit provisions of present law.

Effective Date

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

2. Election to treat cutting of timber as a sale or exchange

Present Law

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

Description of Proposal

Under the proposal, the election to treat the cutting of timber as a sale or exchange may be revoked by the taxpayer on a one-time basis.

Effective Date

The proposal is effective on date of enactment.

3. Capital gains treatment to apply to outright sales of timber by landowner

Present Law

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

Description of Proposal

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

Effective Date

The proposal applies to sales of timber after date of enactment.

4. Modified safe harbor rules for timber REITs

Present Law

In general

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

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

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. A 100-percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business[45], other than foreclosure property.[46] A safe harbor is provided for certain sales of rent producing real property that otherwise might be considered prohibited transactions. The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year. The safe harbor only applies to property that has been held by the REIT for at least four years. In addition, property is eligible for the safe harbor only if the aggregate expenditures made directly or indirectly by the REIT during the four-year period prior to date of sale do not exceed 30 percent of the net selling price of the property.

Certain timber income

REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT to its taxable REIT subsidiary, which cuts and logs the trees and processes the timber to produce lumber, or lumber products such as plywood or composite. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real

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

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

property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[47]

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than five percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[48]

Special rules for Taxable REIT subsidiaries

Under an exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a REIT[49] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[50]

Description of Proposal

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

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

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

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

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

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

(2) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;[51]

(3) The aggregate expenditures made by the REIT (or a partner of the REIT) during the four-year period preceding the date of sale that are includible in the basis of the property and that are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland must not exceed five percent of the net selling price of the property;[52]

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[51] Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (i.e., silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods, grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); (2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4) nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; (7) initial stand fertilization, up through stand establishment; (8) construction cost of road to be used for removal of logs or fire protection; (9) environmental costs (i.e., habitat conservation plans); (10) any post stand capital establishment costs (e.g., "mid-term fertilization costs)."

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

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

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

(6) The sales price on the sale of the property to a taxable REIT subsidiary cannot be based in whole or in part on the income or profits that the subsidiary derives from the sales of such properties.

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

Effective Date

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

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property incurred by the REIT (e.g., engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber).

III. ADDITIONAL REVENUE OFFSETS

A. International Tax

1. Clarification of banking business for purposes of determining investment of earnings in U.S. property

Present Law

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[53] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

Description of Proposal

The proposal provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with "banks" (including foreign branches) as defined under section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)), without regard to sections 2(c)(1)(C) and 2(c)(1)(G) of such Act.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited*.

Effective Date

This proposal is effective on the date of enactment.

2. Prohibition on nonrecognition of gain through complete liquidation of holding company

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

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[53] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

Description of Proposal

The proposal treats as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years.

Effective Date

The proposal is effective for distributions occurring on or after the date of enactment.

3. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (sections 951-964), the passive foreign investment company rules (sections 1291-1298), and the foreign personal holding company rules (sections 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[54] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[55] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[56]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[57] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[58] As in the case of OID, the Treasury regulations additionally provide

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[54] Section 163(e)(1).

[55] Section 163(e)(3).

[56] Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue has in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

[57] Section 267(a)(2).

[58] Treas. Reg. sec. 1.267(a)-3(b)(1), (c).

that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[59]

Description of Proposal

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of all of the direct or indirect U.S. owners of the related foreign person under the relevant inclusion rules. Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid. The provision provides an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the provision grants the Secretary regulatory authority to determine the manner of proper allocations to shareholders, and to provide exceptions to these rules. It is intended that these rules should apply to OID, interest, and amounts other than interest that are non-effectively connected foreign source income of a related foreign person.

Effective Date

The provision is effective for payments accrued on or after date of enactment.

4. Apply earnings-stripping rules to partnerships and S corporations

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[60] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

The present-law earnings stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as debt of the corporate partner for purposes of applying the earnings

[59] Treas. Reg. sec. 1.267(a)-3(c)(4).

[60] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

stripping limitation to its own interest payments.[61] In addition, interest paid or accrued by a partnership is treated as interest expense of a corporate partner, with the result that a deduction for the interest expense may be disallowed if that expense would be disallowed under the earnings stripping rules if paid by the corporate partner itself.[62] The proposed regulations also provide that the earnings stripping rules do not apply to subchapter S corporations.[63] Thus, under present law and the proposed regulations, a partnership or S corporation generally is allowed a deduction for interest paid or accrued on indebtedness that it issues that otherwise would be disallowed under the earnings stripping rules in the case of a subchapter C corporation.

Description of Proposal

The proposal provides that the deduction for interest paid or accrued by partnerships and S corporations is subject to disallowance under the earnings stripping rules if the partnership or S corporation meets the tests that would apply under present law if the partnership or S corporation were a C corporation. Thus, for example, the deduction for interest paid by a partnership to a related person that is exempt from tax would be disallowed if the debt-equity ratio of the partnership exceeds 1.5 to 1 and the interest expense of the partnership exceeds 50 percent of the partnership's adjusted taxable income. As a result, no deduction for this interest would be available to any of the partners. Although an S corporation cannot have foreign shareholders under present law, "disqualified interest" subject to the earnings stripping rules would include interest paid to tax-exempt organizations that are shareholders of the S corporation and interest paid to other related parties as defined under the current rules.

The proposal incorporates a rule attributing partnership debt to a corporate partner for purposes of applying the earnings stripping rules to the corporation.[64] The rule attributing partnership interest expense to corporate partners for potential disallowance under the earnings stripping rules[65] apply under the proposal only after the earnings stripping rules have been applied at the partnership level. If interest expense of the partnership is disallowed under the proposal, there is no deduction allocated to the corporate partners. If the interest deduction is not disallowed at the partnership level, the amount allocated to a corporate partner would be subject again to disallowance under the proposed Treasury regulations based upon the attributes of the corporate partner.

Effective Date

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

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[61] Prop. Treas. reg. sec. 1.163(j)-3(b)(3).

[62] Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[63] Prop. Treas. reg. sec. 1.163(j)-1(a)(i).

[64] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

[65] This rule currently is contained in Prop. Treas. reg. sec. 1.163(j)-2(c)(5).

5. Excise tax on stock compensation of insiders of inverted corporations

Present Law

The income taxation of a nonstatutory[66] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[67] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Description of Proposal

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's inversion date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934

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[66] Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

[67] If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

with respect to the corporation, or any member of the corporation's expanded affiliated group,[68] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[69] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the proposal.

Specified stock compensation subject to the excise tax includes any payment[70] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the proposal applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value

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[68] An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

[69] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

[70] Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual is paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the inversion transaction, and to any specified stock compensation awarded in the six-month period beginning with the inversion transaction. As a result, for example, if a corporation were to cancel outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Treasury Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable twelve-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the inversion or to any stock acquired pursuant to such exercise to the extent income is recognized under section 83. The excise tax also does not apply to any specified stock compensation that is sold, exchanged, distributed or cashed-out during such period in a transaction in which gain or loss is recognized in full.

For specified stock compensation held on the inversion date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the inversion date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the inversion date is valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Treasury Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the proposal. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the inverted corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Treasury Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance would include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Treasury Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the section.

Effective Date

The proposal is effective as of July 11, 2002, except that periods before July 11, 2002, are not taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the inversion date.

6. Reinsurance agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[71] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[72] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[73] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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[71] Sec. 845(a).

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

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

No regulations have been issued under section 845(a). It is expected that the Treasury Secretary will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

Effective Date

The proposal is effective for any risk reinsured after April 11, 2002.

7. Reporting of taxable mergers and acquisitions

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

Description of Proposal

Under the proposal, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[74]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements is extended to failures to comply with the requirements set forth under the proposal.

Effective Date

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

[74] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

B. Other Revenue Offsets

1. Modify qualification rules for tax-exempt property and casualty insurance companies

Present Law

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshhold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

Description of Proposal

The proposal modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Under the proposal, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account. The proposal expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the proposal. Under the proposal, the term "insurance company" means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a) and new sec. 831(c)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.[75] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

[75] *See, e.g., Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).

The proposal also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (without regard to whether such premiums exceed $350,000) (sec. 831(b)). As under present law, for purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the proposal, including, for example, by attempts to characterize as premiums any income that is other than premium income.

Effective Date

The proposals are effective for taxable years beginning after December 31, 2003.

2. Recognize cancellation of indebtedness income realized on satisfaction of debt with partnership interest

Present Law

Under present law, a corporation that transfers of its stock in satisfaction of its debt must recognize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock.[76] Prior to enactment of this present-law provision in 1993, case law provided that a corporation did not recognize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of debt (referred to as the "stock-for-debt exception").[77]

When cancellation of indebtedness income is realized by a partnership, it generally is allocated among the partners in accordance with their distributive shares. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations.[78] The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

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[76] Sec. 108(e)(8).

[77] *E.g.*, *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *nonacq.* 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.* 1943 C.B. 1.

[78] Sec. 108(a).

In the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly requires the partnership to realize cancellation of indebtedness income. Thus, it is unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt exception. It also is unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[79]

Description of Proposal

The proposal provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The proposal applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the proposal is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the proposal, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Effective Date

This proposal is effective for cancellations of indebtedness occurring on or after the date of enactment.

3. Modification of the straddle rules

Present Law

In general

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in

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[79] *See, e.g.*, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934); *American Seating Co. v. Commissioner*, 14 B.T.A. 328, *aff'd in part and rev'd in part*, 50 F.2d 681 (7th Cir. 1931); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940); Rev. Rul. 91-31, 1991-1 C.B. 19.

the straddle.[80] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

Positions in stock

The straddle rules also generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Although the straddles rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules do not apply if the option is a "qualified covered call option" written by the taxpayer. In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

The stock exception from the straddle rules has been curtailed severely by legislative amendment and regulatory interpretation. Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[81]

Unbalanced straddles

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[82] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation--share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is

[80] Sec. 1092.

[81] Prop. Reg. sec. 1.1092(d)-2(c).

[82] Sec. 1092(c)(2)(B).

also an offsetting position to the put option--notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting to the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[83] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[84] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock--i.e., the number of shares specified in the costless collar--because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) and (3) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

Description of Proposal

The proposal modifies the straddle rules in three respects: (1) permit taxpayers to identify offsetting positions of a straddle; (2) provide a special rule with respect to certain physically settled positions of a straddle; and (3) repeal the stock and qualified covered call exceptions from the straddle rules.

Under the proposal, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. However, taxpayers are permitted to identify offsetting positions of a straddle only to the extent that the fair market value of the straddle position already held by the taxpayer at the inception of the straddle equals or exceeds its adjusted basis in the hands of the taxpayer. Straddle period losses are allocated to the identified straddle in proportion to the unrealized straddle period gains of the identified straddle and are capitalized into the basis of the offsetting position(s) that comprises the other leg(s) in the

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[83] PLR 199925044 (Feb. 3, 1999).

[84] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

identified straddle. In addition, the proposal provides authority to issue Treasury regulations that would: (1) specify the application of the straddle rules to a taxpayer who fails to properly identify the positions of the straddle on a timely basis; (2) reclassify improperly or inappropriately identified positions; (3) coordinate the provision with the wash sale rules under section 1091; and (4) provide an ordering rule for dispositions of less than an entire lot that has been partially offset in a properly identified straddle.

The proposal also requires taxpayers that settle an option or forward contract by delivering property to treat the settlement as a two-step transaction for purposes of applying the straddle rules. With respect to a physically settled option or forward contract, the taxpayer is required to treat the option or forward contract as if it was terminated for its fair market value immediately before settlement. Any resulting loss is capitalized into the offsetting position(s) that comprises the other leg(s) of the straddle. The taxpayer then is treated as selling the property used to physically settle the option or forward contract.

The proposal also eliminates the exceptions from the straddle rules for stock and qualified covered call options. Thus, offsetting positions involving actively traded stock generally constitute a straddle.

Effective Date

This proposal is effective for positions established on or after the date of enactment.

4. 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 nor that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised with 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

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.

C. Additional Revenue Offsets

1. Modify definition of controlled group of corporations

Present Law

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

Table 2.–Marginal Federal Corporate Income Tax Rates

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

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

The component members of a controlled group of corporations are limited to one amount in each of the taxable income brackets shown above.[85] For this purpose, a controlled group of corporations means a parent-subsidiary controlled group and a brother-sister controlled group.

A brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of all stock, and (2) more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to the corporation.

Description of Proposal

Under the proposal, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50 percent of percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account

[85] Components members are also limited to one alternative minimum tax exemption and one accumulated earnings credit.

the stock ownership of each person only to the extent the stock ownership is identical with respect to the corporation.

Effective Date

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

2. Limit deduction for charitable contributions of patents and similar property

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[86] The amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets.[87]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[88] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[89]

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[86] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[87] *See* sec. 1221(a)(3), 1231(b)(1)(C).

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

[89] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

In general, charitable organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organization may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest.

Description of Proposal

In general

The proposal provides that the amount of the deduction for charitable contributions of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property ("intellectual property") may not exceed the taxpayer's basis in the contributed property. The proposal permits a taxpayer to take such a deduction and to retain a right to receive certain payments from the donee organization, provided that the donor relinquishes ownership of the entire property.

The proposal does not change the rules for charitable contributions of intellectual property that under present law provide the donor a basis deduction (for example, copyrights described in sections 1221(a)(3) and 1231(b)(1)(C)). The proposal does not change present law rules regarding private inurement and private benefit.

Donor's right to receive certain payments

The donor's right to receive payments is limited to payments made by the donee organization and is subject to amount and time limitations. No single payment to the taxpayer made by the donee organization may exceed 50 percent of the amount of the corresponding payment received by the donee organization from a third party with respect to the contributed property. Payments are not permitted if made after the earlier of the expiration of the legal life of the contributed property or the date that is twenty years after the date of the contribution. The right to receive payments does not include a right to receive any portion of proceeds from a sale of the contributed property by the donee. The Secretary of the Treasury is authorized to apply similar limitations in cases where the donee does not receive payments from a third party with respect to the contributed property.[90]

The proposal provides that permitted payments will constitute ordinary income recognized by the donor when received, regardless of the donor's method of accounting. In cases where the donor receives permitted payments, the proposal overrides present-law rules regarding contributions of partial interests and bargain sales to the extent that they otherwise apply. In cases where the donor has a right to receive payments not permitted by the proposal, no charitable contribution deduction is allowed and the payments received by the donor are taxed under the generally applicable law.

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[90] For example, if the donee organization does not receive a payment, such as a royalty, from a third party with respect to the property, the Secretary of the Treasury is authorized to permit payments by the donee organization to the donor, but only to the extent that the benefit conferred to the donor does not exceed the benefit to the donee.

<u>Treasury guidance regarding abusive situations</u>

The proposal provides the Secretary of the Treasury with the authority to issue regulations or other guidance to prevent avoidance of the purposes of the proposal. In general, the provision is intended to prevent taxpayers from claiming a deduction in excess of basis with respect to charitable contributions of intellectual property. A taxpayer would contravene the purposes of the provision, for example, by engaging in transactions or other activity that manipulated the basis of the contributed property or changed the form of the contributed property in order to increase the amount of the deduction. This might occur, for instance, if a taxpayer, for the purpose of claiming a larger deduction, engaged in activity that increased the basis of the contributed property by using related parties, pass-thru entities, or other intermediaries or means. The purpose of the proposal also would be abused if a taxpayer changed the form of the property in order to claim a larger deduction by, for example, embedding the property into a product, contributing the product, and claiming a fair market value deduction based in part on the fair market value of the embedded property. In such abusive cases, any guidance issued by the Secretary of the Treasury shall provide that the taxpayer is required to separate the embedded property from the related product and treat the charitable contribution as contributions of distinct properties, with each property subject to the applicable deduction rules.

<u>Effective Date</u>

The provision is effective for contributions made after October 1, 2003.

3. Extension of customs user fees

<u>Present Law</u>

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 103-182 which extended authorization for the collection of these fees through fiscal year 2003.

<u>Description of Proposal</u>

The proposal extends the passenger and conveyance processing fees and the merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2013.

<u>Effective Date</u>

The proposal is effective upon the date of enactment.

4. Deposits made to suspend the running of interest on potential underpayments

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

Description of Proposal

In general

The proposal allows a taxpayer to deposit cash with the IRS that the may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is paid by the deposited amount for the period the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the $5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Withdrawal of amounts

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Thus, the interest received on withdrawn deposits will not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

Effective Date

The proposal applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

5. Establish specific class lives for utility grading costs

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[91] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

Description of Proposal

The proposal assigns a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The proposal includes these assets in the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective Date

The proposal is effective for electric and gas utility clearing and grading costs incurred after the date of enactment.

6. Repeal of ten-percent rehabilitation tax credit

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures (sec. 47).

A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

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[91] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, the building must have been substantially rehabilitated, and it must have been placed in service before the beginning of the rehabilitation. A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

Description of Proposal

The proposal provision repeals the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936. The proposal retains the present-law 20-percent credit for rehabilitation expenditures with respect to a certified historic structure.

Effective Date

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

7. Expansion of limitation on depreciation of certain passenger automobiles

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over five years. However, section 280F limits the annual depreciation deduction with respect to certain passenger automobiles.[92]

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[92] The limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles (subject to the such limitation) placed in service in 2002, the maximum amount of allowable depreciation is $7,660 for the year in which the vehicle was placed in service, $4,900 for the second year, $2,950 for the third year, and $1,775 for the fourth and later years. This limitation applies to the combined depreciation deduction provided under present law for depreciation, including section 179 expensing and the temporary 30 percent additional first year depreciation allowance. For luxury automobiles eligible for the 50% additional first depreciation allowance the first year limitation is increased by an additional $3,050.

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[93] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sports utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment (sec. 179). The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[94] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[95] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.

Description of Proposal

The proposal limits the ability of taxpayers to claim deductions under section 179 for certain vehicles not subject to section 280F to $25,000. The proposal applies to sports utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the present law 6,000 pound rating). For this purpose, a sports utility vehicle is defined to exclude any vehicle that: (1) does not have a primary load device or container attached; (2) has a seating capacity of more than 12 individuals; (3) is designed for more than nine individuals in seating rearward of the driver's seat; (4) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least 72.0 inches in interior length; or (5) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

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[93] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

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

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

Effective Date

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

8. Increase age limit under section 1(g)

Present Law

Filing requirements for children

Single unmarried individuals eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has (1) earned income only over $4,750 (for 2003), (2) unearned income only over the minimum standard deduction amount for dependents ($750 in 2003), or (3) both earned income and unearned income totaling more than the smaller of (a) $4,750 (for 2003) or (b) the larger of (i) $750 (for 2003), or (ii) earned income plus $250.[96] Thus, if a dependent child has less than $750 in gross income, the child does not have to file an individual income tax return for 2003.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income under section 1(g)

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[97] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year, (2) the child's investment income was more than $1,500 (for 2003) and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($750 for 2003), and (2) the

[96] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 3, Table 1 (2002).

[97] Sec. 1(g).

greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[98] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[99]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's unearned income

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[100]

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[98] Sec. 1(g)(4).

[99] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 6 (2002).

[100] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

(2) such income is more than the minimum standard deduction amount for dependents ($750 in 2003) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,500 for 2003). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $75 (in 2003), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($750 in 2003).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[101] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[102] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[103]

Taxation of compensation for services under section 1(g)

Compensation for a child's services, even though not retained by the child, is considered the gross income of the child, not the parent, even if the compensation is not received by the child (e.g. is the parent's income under local law).[104] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[105]

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[101] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 8 (2002).

[102] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

[103] Sec. 1(g)(7)(B).

[104] Sec. 73(a).

[105] Sec. 6201(c).

Description of Proposal

The proposal increases the age of minors to which the kiddie tax provisions apply from under 14 to under 18.

Effective Date

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

9. Provide consistent amortization period for intangibles

Present Law

At the election of the taxpayer, start-up expenditures[106] and organizational expenditures[107] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[108] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

Description of Proposal

The proposal modifies the treatment of start-up and organizational expeditures. A taxpayer would be allowed to elect to deduct up to $5,000 each of start-up and organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000

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[106] Sec. 195

[107] Secs. 248 and 709.

[108] Treas. Reg. sec. 1.195-1.

amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective Date

The proposal is effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

10. Deny installment sale treatment for all readily tradable debt

Present Law

Under present law, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[109] However, the installment method is not available if the taxpayer sells property in exchange for a readily tradable evidence of indebtedness that is issued by a corporation or a government or political subdivision. Instead, the receipt of such indebtedness is treated as payment on the installment note.[110]

No similar provision under present law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

Description of Proposal

The proposal denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable under present-law rules, regardless of the nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

Effective Date

The proposal is effective for sales occurring on or after date of enactment.

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[109] Sec. 453.

[110] Sec. 453(f)(3).

11. Limitation of tax benefits for leases to certain tax exempt entities

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[111] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[112] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[113]

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

Description of Proposal

The proposal limits the amount of allowable deductions or losses with respect to certain service contracts or leases to the amount of income reported with respect to each such service contract or lease.[114] The proposal applies to leases and certain service contracts and similar arrangements with a tax-exempt entity. For purposes of the proposal a tax-exempt entity is defined as the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing; an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter one of

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[111] Sec. 168(g)(3)(A).

[112] Sec. 168(h)(1).

[113] Sec. 168(h)(2).

[114] It is intended that the limitations would be similar to the passive activity loss rules of section 469.

the Code; and any foreign government, political subdivision thereof, or any agency or instrumentality of any of the foregoing.

Effective Date

The proposal is effective for leases and other similar arrangements entered into after the date of enactment.

12. Mandatory basis adjustments in connection with partnership distributions and transfers of partnership interests

Present Law

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[115] If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[116] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[117] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[118] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's

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[115] Sec. 743(a).

[116] Sec. 743(b).

[117] Sec. 731(a) and (b).

[118] Sec. 732(b).

adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[119]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[120] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[121] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Description of Proposal

Under the proposal, adjustments to the basis of partnership property in the event of a partnership distribution or the transfer of a partnership interest are required, not elective as under present law. However, the basis adjustments are elective, as under present law, in the case of the transfer of a partnership interest by reason of the partner's death.

Effective Date

The proposal applies to transfers and distributions after the date of enactment.

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[119] Sec. 732(a).

[120] Sec. 734(a).

[121] Sec. 734(b).