

EXCEPTIONS FOR CERTAIN ACTIVE FINANCING INCOME AND NON-  
 RECOGNITION OF GAIN ON SALE OF STOCK IN AGRICULTURAL PROC-  
 ESSORS TO CERTAIN FARMERS' COOPERATIVES

OCTOBER 9, 1997.—Committed to the Committee of the Whole House on the State  
 of the Union and ordered to be printed

Mr. ARCHER, from the Committee on Ways and Means,  
 submitted the following

REPORT

[To accompany H.R. 2513]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 2513) to amend the Internal Revenue Code of 1986 to restore and modify the provision of the Taxpayer Relief Act of 1997 relating to exempting active financing income from foreign personal holding company income and to provide for the nonrecognition of gain on the sale of stock in agricultural processors to certain farmers' cooperatives, having considered the same, reports favorably thereon with an amendment and recommend that the bill as amended do pass.

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The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

**SECTION 1. EXEMPTION FOR ACTIVE FINANCING INCOME.**

(a) EXEMPTION FROM FOREIGN PERSONAL HOLDING COMPANY INCOME.—Section 954 of the Internal Revenue Code of 1986 (as amended by subsection (d)) is amended by adding at the end the following new subsection:

“(h) SPECIAL RULE FOR INCOME DERIVED IN THE ACTIVE CONDUCT OF INSURANCE BUSINESSES AND BANKING, FINANCING, OR SIMILAR BUSINESSES.—

“(1) IN GENERAL.—For purposes of subsection (c)(1), foreign personal holding company income shall not include income which is—

“(A) derived in the active conduct by a controlled foreign corporation of a banking, financing, or similar business, but only if—

“(i) the corporation is predominantly engaged in the active conduct of such business, and

“(ii) such income is derived from transactions with customers located within the country under the laws of which the corporation is created or organized,

“(B) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from the investments made by a qualifying insurance company of its reserves or of 80 percent of its unearned premiums (as both are determined in the manner prescribed under paragraph (4)), or

“(C) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from investments made by a qualifying insurance company of an amount of its assets equal to—

“(i) in the case of property, casualty, or health insurance contracts, one-third of its premiums earned on such insurance contracts during the taxable year (as defined in section 832(b)(4)), and

“(ii) in the case of life insurance or annuity contracts, 10 percent of the reserves described in subparagraph (B) for such contracts.

“(2) PREDOMINANTLY ENGAGED.—For purposes of paragraph (1)(A), a controlled foreign corporation shall be deemed predominantly engaged in the active conduct of a banking, financing, or similar business only if—

“(A) more than 70 percent of its gross income is derived from such business from transactions with customers which are located within the country under the laws of which the corporation is created or organized, or

“(B) the corporation is—

“(i) engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified by the Secretary in regulations), or

“(ii) engaged in the active conduct of a securities business and is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934 or is registered as a Government securities broker or dealer under section 15C(a) of such Act (or is any other corporation not so registered which is specified by the Secretary in regulations).

“(3) PRINCIPLES FOR DETERMINING INSURANCE INCOME.—Except as provided by the Secretary, for purposes of paragraphs (1) (B) and (C)—

“(A) in the case of any contract which is a separate account-type contract (including any variable contract not meeting the requirements of section 817), income credited under such contract shall be allocable only to such contract, and

“(B) income not allocable under subparagraph (A) shall be allocated ratably among contracts not described in subparagraph (A).

“(4) METHODS FOR DETERMINING UNEARNED PREMIUMS AND RESERVES.—For purposes of paragraph (1)(B)—

“(A) PROPERTY AND CASUALTY CONTRACTS.—The unearned premiums and reserves of a qualifying insurance company with respect to property, cas-

uality, or health insurance contracts shall be determined using the same methods and interest rates which would be used if such company were subject to tax under subchapter L.

“(B) LIFE INSURANCE AND ANNUITY CONTRACTS.—The amount of the reserve of a qualifying insurance company for any life insurance or annuity contract shall be equal to the greater of—

“(i) the net surrender value of such contract (as defined in section 807(e)(1)(A)), or

“(ii) the reserve determined under paragraph (5).

“(C) LIMITATION ON RESERVES.—In no event shall the reserve determined under this paragraph for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining foreign statement reserves (less any catastrophe, deficiency, or similar reserves).

“(5) AMOUNT OF RESERVE.—The amount of the reserve determined under this paragraph with respect to any contract shall be determined in the same manner as it would be determined if the qualifying insurance company were subject to tax under subchapter L, except that in applying such subchapter—

“(A) the interest rate determined for the foreign country in which such company is created or organized and which, except as provided by the Secretary, is calculated in the same manner as the Federal mid-term rate under section 1274(d) shall be substituted for the applicable Federal interest rate,

“(B) the highest assumed interest rate permitted to be used in determining foreign statement reserves shall be substituted for the prevailing State assumed interest rate, and

“(C) tables for mortality and morbidity which reasonably reflect the current mortality and morbidity risks in the foreign country shall be substituted for the mortality and morbidity tables otherwise used for such subchapter.

“(6) DEFINITIONS.—For purposes of this subsection—

“(A) QUALIFYING INSURANCE COMPANY.—The term ‘qualifying insurance company’ means any entity which—

“(i) is subject to regulation as an insurance company by the country under the laws of which the entity is created or organized,

“(ii) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks located within such country, and

“(iii) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

“(B) LIFE INSURANCE OR ANNUITY CONTRACT.—For purposes of this section and section 953, the determination of whether a contract issued by a controlled foreign corporation is a life insurance contract or an annuity contract shall be made without regard to sections 72(s), 101(f), 817(h), and 7702 if—

“(i) such contract is regulated as a life insurance or annuity contract by the country under the laws of which the corporation is created or organized, and

“(ii) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.

“(C) NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—A noncancellable accident and health insurance contract shall be treated for purposes of this subsection in the same manner as a life insurance contract except that paragraph (4)(B)(i) shall not apply.

“(D) LOCATED.—

“(i) IN GENERAL.—The determination of where a customer is located shall be made under rules prescribed by the Secretary.

“(ii) SPECIAL RULE FOR QUALIFIED BUSINESS UNITS.—Gross income derived by a corporation’s qualified business unit (within the meaning of section 989(a)) from transactions with customers which are located in the country in which the qualified business unit both maintains its principal office and conducts substantial business activity shall be treated as derived from transactions with customers which are located within the country under the laws of which the controlled foreign corporation is created or organized.

“(E) CUSTOMER.—

“(i) IN GENERAL.—The term ‘customer’ means, with respect to any controlled foreign corporation, any person which has a customer relationship with such corporation.

“(ii) EXCEPTION FOR RELATED, ETC. PERSONS.—A person who is a related person (as defined in subsection (d)(3)), an officer, a director, or an employee with respect to any controlled foreign corporation shall not be treated as a customer with respect to any transaction if a principal purpose of such transaction is to satisfy any requirement of this subsection.

“(7) ANTI-ABUSE RULES.—For purposes of applying this subsection and subsection (c)(2)(C)(ii), there shall be disregarded any item of income, gain, loss, or deduction with respect to any transaction or series of transactions one of the principal purposes of which is qualifying income or gain for the exclusion under this section, including—

“(A) any change in the method of computing reserves or any other transaction or series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of such exclusion through the application of this subsection, and

“(B) organizing entities in order to satisfy any same country requirement under this subsection.

“(8) COORDINATION WITH OTHER PROVISIONS.—

“(A) SECTION 901(k).—

“(i) IN GENERAL.—The amount of qualified taxes (as defined in section 901(k)(4)) to which paragraphs (1) and (2) of section 901(k) do not apply by reason of paragraph (4) of such section 901(k) shall be reduced by an amount which bears the same ratio to such qualified taxes as the amount of income from the active conduct of a securities business which is not subpart F income solely by reason of this subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) bears to the total income from the active conduct of a securities business by a controlled foreign corporation which is not subpart F income. The determination under the preceding sentence shall be made by treating all members of an affiliated group as 1 corporation. For purposes of this clause, the term ‘subpart F income’ has the meaning given such term by section 952(a) but determined without regard to section 952(c) and paragraphs (3) and (4) of subsection (b) of this section.

“(ii) ELECTION NOT TO HAVE SUBSECTION AND CERTAIN OTHER PROVISIONS APPLY.—Clause (i) shall not apply for any taxable year of a foreign corporation if such corporation (and all members of the affiliated group of which such corporation is a member) elect not to have this subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) apply for such taxable year.

“(B) TREATMENT OF INCOME TO WHICH SECTION 953 APPLIES.—Subparagraphs (B) and (C) of paragraph (1) shall not apply to investment income allocable to contracts that insure related party risks or risks located in a foreign country other than the country in which the qualifying insurance company is created or organized.

“(9) APPLICATION.—This subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) shall apply only to the first full taxable year of a foreign corporation beginning after December 31, 1997, and before January 1, 1999, and to taxable years of United States shareholders with or within which such taxable year of such foreign corporation ends.”

(b) SPECIAL RULES FOR DEALERS.—Section 954(c)(2)(C) of such Code is amended to read as follows:

“(C) EXCEPTION FOR DEALERS.—Except as provided by regulations, in the case of a regular dealer in property (within the meaning of paragraph (1)(B)), forward contracts, option contracts, or similar financial instruments (including notional principal contracts and all instruments referenced to commodities), there shall not be taken into account in computing foreign personal holding income—

“(i) any item of income, gain, deduction, or loss (other than any item described in subparagraph (A), (E), or (G) of paragraph (1)) from any transaction (including hedging transactions) entered into in the ordinary course of such dealer’s trade or business as such a dealer, and

“(ii) if such dealer is a dealer in securities (within the meaning of section 475), any interest or dividend or equivalent amount described in subparagraph (E) or (G) of paragraph (1) from any transaction (including any hedging transaction or transaction described in section

956(c)(2)(J)) entered into in the ordinary course of such dealer's trade or business as such a dealer in securities, but only if employees of the dealer which are located in the country under the laws of which the dealer is created or organized (or in the case of a qualified business unit described in section 989(a) which both maintains its principal office and conducts substantial business activity in a country, employees of such unit which are located in such country) materially participate in such transaction."

(c) EXEMPTION FROM FOREIGN BASE COMPANY SERVICES INCOME.—Paragraph (2) of section 954(e) of such Code (as amended by subsection (d)) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by adding at the end the following:

"(C)(i) a transaction by the controlled foreign corporation if the income from the transaction is not foreign personal holding company income by reason of subsection (h), or

"(ii) a transaction by the controlled foreign corporation if subsection (c)(2)(C)(ii) applies to such transaction."

(d) REPEAL OF CANCELED PROVISIONS.—Section 1175 of the Taxpayer Relief Act of 1997, and the amendments made by such section, are hereby repealed, and the Internal Revenue Code of 1986 shall be applied and administered as if such section (and amendments) had never been enacted.

(e) BUDGETARY TREATMENT.—For purposes of section 10213 of the Balanced Budget Act of 1997, the provisions of this section shall be considered to have been enacted as part of the Taxpayer Relief Act of 1997.

**SEC. 2. NONRECOGNITION OF GAIN ON SALE OF STOCK TO CERTAIN FARMERS' COOPERATIVES.**

(a) IN GENERAL.—Part III of subchapter O of chapter 1 of the Internal Revenue Code of 1986 (relating to nontaxable exchanges) is amended by inserting after section 1042 the following new section:

**"SEC. 1042A. SALES OF STOCK TO CERTAIN FARMERS' COOPERATIVES.**

"(a) NONRECOGNITION OF GAIN.—If—

"(1) the taxpayer elects the application of this section with respect to any sale of qualified agricultural processor stock,

"(2) the taxpayer purchases qualified replacement property within the replacement period, and

"(3) the requirements of subsection (c) are met with respect to such sale, then the gain (if any) on such sale which would be recognized as long-term capital gain shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property. The preceding sentence shall not apply to a sale by an eligible farmers' cooperative.

"(b) LIMITATION.—

"(1) IN GENERAL.—If subsection (a) applies to the sale of any stock by the taxpayer in a qualified agricultural processor, the aggregate amount of gain taken into account by the taxpayer under subsection (a) with respect to stock in such processor shall not exceed the amount of the limitation under paragraph (2) which is allocated to such sale by the eligible farmers' cooperative.

"(2) ALLOCATION.—The amount allocated under this paragraph by any cooperative with respect to stock acquired by such cooperative during any taxable year of such cooperative shall not exceed \$75,000,000.

"(3) AGGREGATION RULES.—All eligible farmers' cooperatives which are under common control (within the meaning of subsection (a) or (b) of section 52) shall be treated as 1 cooperative for purposes of paragraph (2), and the limitation under such paragraph shall be allocated among such cooperatives in such manner as the Secretary shall prescribe.

"(c) REQUIREMENTS TO QUALIFY FOR NONRECOGNITION.—A sale of qualified agricultural processor stock meets the requirements of this subsection if—

"(1) SALE TO ELIGIBLE FARMERS' COOPERATIVE.—Such stock is sold to an eligible farmers' cooperative.

"(2) SPECIAL RULE FOR CERTAIN COOPERATIVES.—

"(A) IN GENERAL.—In the case of a sale of such stock to an eligible farmers' cooperative described in subparagraph (B), the processor purchased, during at least 3 of the 5 most recent taxable years of such processor ending on or before the date of the sale, more than one-half of the agricultural or horticultural products to be refined or processed by such processor from such cooperative or farmers who are members of such cooperative.

“(B) COOPERATIVES DESCRIBED.—A cooperative is described in this subparagraph with respect to any sale if, for any taxable year ending before the date of such sale—

“(i) such cooperative had gross receipts of more than \$1,000,000,000,

or

“(ii) such cooperative sold more than a de minimis amount of specialty produce.

“(C) SPECIALTY PRODUCE.—For purposes of subparagraph (B), the term ‘specialty produce’ means any agricultural or horticultural product other than wheat, feed grains, oil seeds, cotton, rice, cattle, hogs, sheep, or dairy products.

“(D) SPECIAL RULES.—

“(i) GROSS RECEIPTS.—For purposes of subparagraph (B)(i), rules similar to the rules of paragraph (2), and subparagraphs (B) and (C) of paragraph (3), of section 448(c) shall apply.

“(ii) PREDECESSOR.—Any reference in this paragraph to a cooperative or processor shall be treated as including a reference to any predecessor thereof.

“(3) COOPERATIVE MUST HOLD 100 PERCENT OF STOCK AFTER SALE.—The eligible farmers’ cooperative owns, immediately after the sale, all of the qualified agricultural processor stock of the corporation.

“(4) WRITTEN STATEMENT AND HOLDING PERIOD.—Requirements similar to the requirements of paragraphs (3) and (4) of section 1042(b) are met.

“(d) DEFINITIONS.—For purposes of this section—

“(1) QUALIFIED AGRICULTURAL PROCESSOR STOCK.—The term ‘qualified agricultural processor stock’ means stock (other than stock described in section 1504(a)(4)) issued by a qualified agricultural processor.

“(2) QUALIFIED AGRICULTURAL PROCESSOR.—The term ‘qualified agricultural processor’ means a domestic C corporation substantially all of the assets of which are used in the active conduct of the trade or business of refining or processing agricultural or horticultural products in the United States.

“(3) ELIGIBLE FARMERS’ COOPERATIVE.—The term ‘eligible farmers’ cooperative’ means an organization to which part I of subchapter T applies and which is engaged in the marketing of agricultural or horticultural products.

“(4) REPLACEMENT PERIOD.—The term ‘replacement period’ means the period which begins 3 months before the date on which the sale of qualified agricultural processor stock occurs and which ends 12 months after the date of such sale.

“(5) QUALIFIED REPLACEMENT PROPERTY.—

“(A) IN GENERAL.—Except as provided in subparagraph (B), the term ‘qualified replacement property’ has the meaning given such term by section 1042(c)(4).

“(B) EXCEPTION.—The term ‘qualified replacement property’ shall not include any security issued by the taxpayer or by any corporation controlled by the taxpayer immediately after the purchase. For purposes of the preceding sentence, the term ‘control’ has the meaning given such term by section 304(c) (determined by substituting ‘10 percent’ for ‘50 percent’ each place it appears in paragraph (1) thereof).

“(e) SPECIAL RULES.—

“(1) IN GENERAL.—Except as otherwise provided in this subsection, rules similar to the rules of paragraphs (5) and (6) of section 1042(c), subsections (d), (e), and (f) of section 1042, section 1016(a)(22), and section 1223(13) shall apply for purposes of this section.

“(2) CERTAIN PROVISIONS NOT TO APPLY.—

“(A) RECOGNITION ON COMPLETE LIQUIDATION.—Section 332 shall not apply to the liquidation into the cooperative or any related person of a qualified agricultural processor if the cooperative or related person acquired the stock in such processor in a sale to which subsection (a) applied.

“(B) DEEMED SALE ELECTION NOT AVAILABLE.—No election may be made under section 338(h)(10) with respect to a sale to which subsection (a) applies.

“(f) RECAPTURE OF TAX BENEFIT WHERE LACK OF CONTINUITY.—

“(1) IN GENERAL.—If there is a recapture event during any taxable year with respect to any sale to an eligible farmers’ cooperative to which this section applied, such cooperative’s tax imposed by this chapter for such taxable year shall be increased by an amount equal to—

“(A) the recapture percentage of the amount allocated under subsection (b) to such sale, multiplied by

“(B) the highest rate of tax imposed by section 11 for such taxable year.  
 “(2) RECAPTURE EVENT.—For purposes of this subsection, a recapture event shall be treated as occurring in any taxable year if—

“(A) any portion of such taxable year is within the 3-year period beginning on the date on which the eligible farmers’ cooperative acquired stock in a qualified agricultural processor in a sale to which this section applied and, as of the close of such portion, there is a decrease in the direct or indirect percentage ownership of such stock held by such cooperative which was not previously taken into account under this subsection, or

“(B) such taxable year is one of the first 5 taxable years ending after the date of such sale and is the third of such taxable years during which one-half or less of the agricultural or horticultural products refined or processed by the qualified agricultural processor are purchased from the eligible farmers’ cooperative or farmers who are members of such cooperative.

“(3) RECAPTURE PERCENTAGE.—For purposes of this subsection, the term ‘recapture percentage’ means—

“(A) in the case of a recapture event described in paragraph (2)(A), the percentage equal to a fraction—

“(i) the numerator of which is the percentage decrease described in paragraph (2)(A), and

“(ii) the denominator of which is the percentage which the qualified agricultural processor stock acquired by the cooperative in a sale to which this section applied bears to all qualified agricultural processor stock in the processor, and

“(B) in the case of a recapture event described in paragraph (2)(B), 100 percent.

In no event shall the recapture percentage for any taxable year exceed 100 percent minus the sum of the recapture percentages for all prior taxable years.

“(4) EXCEPTIONS TO PURCHASE REQUIREMENT.—The purchase requirement of paragraph (2)(B) shall be treated as met for any taxable year if the Secretary determines that such requirement was not met due to 1 or more of the following: flood, drought, or other weather-related conditions, environmental contamination, disease, fire, or other similar extenuating circumstances prescribed by the Secretary.

“(g) COORDINATION WITH SECTION 1042.—No election may be made under this section with respect to any sale if an election is made under section 1042 with respect to such sale.

“(h) REGULATIONS.—The Secretary shall prescribe such regulations as are appropriate to carry out this section, including regulations which treat 2 or more sales which are part of the same transaction as 1 sale.”

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 26(b) of such Code is amended by striking “and” at the end of subparagraph (P), by striking the period at the end of subparagraph (Q) and inserting “, and”, and by adding at the end the following new subparagraph:

“(R) section 1042A(f) (relating to recapture of tax benefit where lack of continuity in certain agricultural processors).”

(2) The table of sections for part III of subchapter O of chapter 1 of such Code is amended by inserting after the item relating to section 1042 the following new item:

“Sec. 1042A. Sales of stock to certain farmers’ cooperatives.”

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales after December 31, 1997.

(d) BUDGETARY TREATMENT.—For purposes of section 10213 of the Balanced Budget Act of 1997, the provisions of this section shall be considered to have been enacted as part of the Taxpayer Relief Act of 1997.

## I. INTRODUCTION

### A. PURPOSE AND SUMMARY

H.R. 2513, as amended, provides modifications to two tax provisions contained in the Taxpayer Relief Act of 1997 (“1997 Act”) that were canceled pursuant to the President’s line item veto authority: (1) temporary exceptions under subpart F for certain of active fi-

nancing income; and (2) nonrecognition of gain on the sale of stock in agricultural processors facilities to certain farmer's cooperatives.

#### B. BACKGROUND AND NEED FOR LEGISLATION

The bill, as amended, is intended to replace the two tax provisions that were canceled by the President's line item veto in the 1997 Act with modifications that are acceptable to the Committee, the Treasury Department, and the President. The Committee worked closely with the Administration and the affected industries to accomplish this goal, which is reflected in the Committee bill as reported.

#### C. LEGISLATIVE HISTORY

H.R. 2513 was introduced by Chairman Archer and Messrs. Hulshof and Rangel on September 23, 1997, and was amended by the Committee in a markup on September 23, 1997. An amendment in the nature of a substitute (offered by Chairman Archer) was adopted by a voice vote, with a quorum present. The bill, as amended, was ordered favorably reported by a voice vote on September 23, 1997, with a quorum present.

## II. EXPLANATION OF THE BILL

### A. EXCEPTIONS UNDER SUBPART F FOR CERTAIN ACTIVE FINANCING INCOME

(sec. 1 of the bill and sec. 954 of the Code)

#### PRESENT LAW

Under the subpart F rules, certain U.S. shareholders of 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. The U.S. 10-percent shareholders of a CFC also 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: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the preceding types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest; income from notional principal contracts; and payments in lieu of dividends.

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 and related person insurance income. Subpart F insur-

ance 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 (Prop. Treas. reg. sec. 1.953-1(a)). Investment income allocable to contracts insuring risks located within the CFC's country of organization generally is taxable as foreign personal holding company income.

Present law provides rules determining whether contracts are treated as life insurance or annuity contracts for Federal income tax purposes. A statutory definition of "life insurance contract," designed to limit the investment orientation of the contract, is provided in section 7702 (and section 101(f) provides similar rules for certain contracts issued before January 1, 1985). Certain variable contracts (other than pension plan contracts) are not treated as annuity, endowment, or life insurance contracts for any period (and any subsequent period) for which the investments made by the underlying segregated asset account are not adequately diversified (sec. 817(h)). In addition, a contract is not treated as an annuity contract unless rules are satisfied with respect to required distributions where the holder dies before the entire interest in the contract has been distributed (sec. 72(s)). Other rules determining whether contracts are treated as life insurance or annuity contracts also apply under present law.

Under a provision enacted as part of the Taxpayer Relief Act of 1997, the foreign tax credits normally available for foreign taxes paid with respect to a dividend are not allowed if the taxpayer has not held the dividend-paying stock for 16 days (46 days in case of preferred stock). Periods during which the taxpayer is protected from risk of loss with respect to the stock generally are disregarded in determining the taxpayer's holding period. An exception from this holding period requirement is provided for foreign taxes with respect to dividends received by a foreign dealer in securities on stock held in its capacity as a dealer.

#### REASONS FOR CHANGE

The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily movable. Prior to the enactment of the 1986 Act, exceptions from the current inclusion rules of subpart F were provided for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company. The Committee is concerned that the 1986 Act's repeal of these exceptions has resulted in the extension of the subpart F provisions to income that is neither passive nor easily moveable. The Committee believes that the provision of exceptions from foreign personal holding company income for income from the active conduct of an insurance, banking, financing or similar business is appropriate.

The provision in the bill is similar to a provision that was contained in the Taxpayer Relief Act of 1997 and that was canceled

by the President in accordance with the Line Item Veto Act. The provision in the bill reflects significant modifications to the canceled provision to address concerns about the breadth of that provision.

#### EXPLANATION OF PROVISION

##### *In general*

The bill provides temporary exceptions from foreign personal holding company income and foreign base company services income for subpart F purposes for certain income that is derived in the active conduct of an insurance, banking, financing or similar business. These exceptions are applicable only for taxable years beginning in 1998.

With respect to income derived in the active conduct of an insurance business, the provision differs from the canceled provision in the Taxpayer Relief Act of 1997 in the following significant respects. First, rather than providing several alternative methods for determining reserves for life insurance and annuity contracts, such reserves are the greater of: (1) the net surrender value of the contracts; or (2) the reserves determined using the U.S. method (i.e., the method that would apply if the company were subject to tax under subchapter L), but using foreign interest rates and foreign mortality and morbidity tables. Second, the special rule for start-up companies that was included in the canceled provision has been eliminated, as has the look-through rule. Third, the bill provides that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), do not apply for purposes of determining whether a contract issued by a CFC is a life insurance or annuity contract under sections 953 and 954 of the Code, provided that (1) the contract is regulated as a life insurance or annuity contract by the country in which the CFC is created or organized, and (2) none of the policyholders, the insureds or annuitants, or the beneficiaries with respect to the contract are U.S. persons.

With respect to income derived in the active conduct of a banking, financing, or similar business, the provision differs from the canceled provision in the Taxpayer Relief Act of 1997 in the following significant respects. First, the exceptions from foreign personal holding company income and foreign base company services income generally apply only to income derived from transactions with customers located in the same country in which the CFC is created or organized (or in which a qualified business unit of the CFC maintains its principal office and conducts substantial business activity). Second, the determination of where a customer is treated as located is made under rules to be prescribed by the Secretary of the Treasury. Third, the look-through rule that was included in the canceled provision for purposes of determining the income eligible for the exceptions has been eliminated. Fourth, the provision includes rules for the coordination of the application of these new exceptions to income from the active conduct of a securities business with the application of the present-law exception for securities

dealers from the dividend holding period requirement provided in section 901(k)(4).

The Committee recognizes that insurance, banking, financing, and similar businesses are businesses the active conduct of which involves the generation of income, such as interest and dividends, of a type that generally is treated as passive for purposes of subpart F. The Committee further recognizes that the line between income derived in the active conduct of such businesses and income otherwise derived by entities so engaged can be difficult to draw. The Committee believes that the treatment of income derived by these businesses under subpart F requires further study and invites the comments of taxpayers and the Treasury Department regarding these issues in general and the exceptions provided by this temporary provision in particular.

*Income from the active conduct of an insurance business*

The bill provides an exception from foreign personal holding company income for certain investment income of a qualifying insurance company with respect to contracts insuring risks located within the CFC's country of creation or organization. The rules of this provision differ from the rules of present-law section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code. Review of this provision's insurance rules would be appropriate when final guidance under section 953 is published by the Treasury Department. Among other issues, this review should consider whether it is more appropriate to determine the reserves for property and casualty contracts of CFCs using the applicable foreign interest rate and, if sufficient data is available, a foreign loss payment pattern, when using the applicable U.S. interest rate and U.S. loss payment pattern results in a materially different reserve amount.

The exception applies to income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums (as defined for purposes of the provision). The provision applies only with respect to contracts insuring same-country risks that are not related party insurance contracts. For this purpose, in the case of property, casualty, or health insurance contracts (other than noncancellable accident and health insurance contracts), unearned premiums and reserves mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums are determined in accordance with section 832(b)(4), and reserves for losses incurred are determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan con-

tracts, or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the foreign country in which the qualifying insurance company was created or organized, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (“AFR”) (within the meaning of section 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, there are applied mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country. In the case of a noncancellable accident and health insurance contract, reserves for such contract are determined using the tax reserve method that would apply if the qualifying insurance company were subject to tax under subchapter L of the Code, with the three modifications described above.

In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve or any similar reserve. This rule applies whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of insurance contract.

The bill provides that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), do not apply for purposes of determining whether a contract issued by a CFC is a life insurance or annuity contract under sections 953 and 954 of the Code, provided that (1) the contract is regulated as a life insurance or annuity contract by the country in which the CFC is created or organized, and (2) none of the policyholders, the insureds or annuitants, or the beneficiaries with respect to the contract are U.S. persons. However, if any such persons are U.S. persons, this exception from the application of those rules does not apply.

The bill also provides an exception for income from the investment of assets equal to (1) one-third of premiums earned during the taxable year on property, casualty, or health insurance contracts (other than noncancellable accident and health insurance contracts), and (2) 10 percent of reserves (determined for purposes of the provision) for life insurance, annuity or noncancellable accident and health insurance contracts.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the provision specifies that, except as provided by the Treasury Secretary, income is allocated to contracts as follows. In the case of a separate-account-type contract (including a variable contract not meeting the requirements of section 817), the income credited under the contract is allocable only to that contract. In-

come not so allocated is allocated ratably among all contracts that are not separate account-type contracts.

Under the bill, a qualifying insurance company means any entity which: (1) is regulated as an insurance company under the laws of the country in which it is created or organized; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks located within the country in which it is created or organized; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The bill clarifies that the rules added by this provision do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to section 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

*Income from the active conduct of a banking, financing, or similar business*

The bill provides an exception from foreign personal holding company income for income that is derived in the active conduct by a CFC of a banking, financing, or similar business from transactions with customers located within the same country under the laws of which the CFC is created or organized. For this purpose, the Committee intends that income derived from the following types of activities will be considered to be income derived in the active conduct of a banking, financing, or similar business:

- (1) regularly making personal, mortgage, industrial, or other loans in the ordinary course of the corporation's trade or business;
- (2) factoring evidences of indebtedness for customers;
- (3) purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;
- (4) issuing letters of credit and negotiating drafts drawn thereunder for customers;
- (5) performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments;
- (6) arranging foreign exchange transactions (including any section 988 transaction within the meaning of section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers;
- (7) arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers;
- (8) underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers;
- (9) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);

(10) providing charge and credit card services or factoring receivables obtained in the course of providing such services;

(11) providing traveler's check and money order services for customers;

(12) providing correspondent bank services for customers;

(13) providing paying agency and collection agency services for customers;

(14) maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority;

(15) engaging in hedging activities directly related to another activity described herein;

(16) repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity);

(17) engaging in financing activities typically provided by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities;

(18) providing financial or investment advisory services, investment management services, fiduciary services, or custodial services;

(19) purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity;

(20) effecting transactions in securities for customers as a securities broker;

(21) investing premiums accepted by insurance brokers or agents for transmittal to insurance companies on behalf of policyholders and other income from insurance brokerage or agency services, except to the extent that the income is derived from transactions that would give rise to foreign base company services income under section 954(e)(1); and

(22) any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

This exception for income derived in the active conduct of a banking, financing, or similar business from transactions with same-country customers applies only if the CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. In this regard, a CFC that would be subject to tax under subchapter L of the Code if it were a domestic corporation is not predominantly engaged in the active conduct of a banking, financing, or similar business. For this purpose, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing or similar business if more than 70 percent of its gross in-

come is derived from such business from transactions with customers located within the same country under the laws of which the corporation is created or organized. Alternatively, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if (1) it is engaged in the active conduct of a banking business and it is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified in regulations) or (2) it is engaged in the active conduct of a securities business and it is registered as a securities broker or dealer or Government securities broker or dealer under the Securities Exchange Act of 1934 (or is any other corporation not so registered which is specified in regulations). In this regard, the Committee intends that these requirements for the active conduct of a banking or securities business will be interpreted in the manner provided in the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); the Committee further intends that these requirements will be considered to be satisfied by an entity that is a qualified bank affiliate or qualified securities affiliate as defined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.

For purposes of this exception, a customer of a CFC is any person that has a customer relationship with the CFC. However, a related person (within the meaning of sec. 954(d)(3)), officer, director, or employee of any CFC is not treated as a customer with respect to any transaction a principal purpose of which is to satisfy any requirement for this exception. In applying this exception, certain income derived by a qualified business unit of a CFC is treated as derived from transactions with customers located in the same country in which the CFC is created or organized. This treatment applies to income derived by a qualified business unit of a CFC from transactions with customers that are located in the country in which the qualified business unit maintains its principal office and conducts substantial business activity. The determination of where a customer is located will be made under rules to be prescribed by the Secretary of the Treasury.

An additional exception from the definition of foreign personal holding company income is provided for certain income derived by a securities dealer within the meaning of section 475. This exception applies to interest or dividends (or equivalent amounts described in sec. 954(c)(1) (E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in section 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if there is material participation in such transaction by employees located in the country under the laws of which the dealer is created or organized (or, in the case of a qualified business unit of the dealer that both maintains its principal office and conducts substantial business in a country, employees located in that country).

#### *Anti-abuse rule*

The bill includes an anti-abuse rule which is applicable for purposes of these exceptions from foreign personal holding company in-

come. For purposes of applying these exceptions, items with respect to a transaction or series of transactions will be disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions. The reach of this anti-abuse rule explicitly includes any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions and the organization of entities in order to satisfy any same country requirement for these exceptions. The Committee intends that factors relevant in determining whether an entity has been organized in a particular country for a principal purpose of qualifying for these exceptions will include, among other things, whether existing and substantial customers are and have been located in that country.

*Foreign base company services income*

The bill also includes a corresponding exception from foreign base company services income. This exception applies to income derived in connection with the performance of services that are directly related to a transaction by the CFC the income from which is not foreign personal holding company income by reason of section 954(h). This exception also applies to income derived in connection with the performance of services that are directly related to a transaction by the CFC to which the additional exception for certain income of dealers applies.

*Coordination with section 901(k)*

The bill includes rules for coordinating these exceptions to foreign personal holding company income and foreign base company services income for certain active financing income with the dividend holding period requirement of section 901(k). Under the bill, the foreign taxes for which credits are allowable by reason of the securities dealer exception to the dividend holding period requirement are reduced by a proportionate amount based on the ratio of (1) the income from the active conduct of a securities business which is not subpart F income solely because of these active financing income exceptions, to (2) the total income from the active conduct of a securities business by a CFC which is not subpart F income (including income to which these exceptions apply). For this purpose, subpart F income is as defined in section 952(a), but calculated without applying the rules of section 954(b) (3) and (4) and without applying the earnings and profits limitations set forth in section 952(c). This rule is applied on an affiliated group basis (i.e., by treating all members of an affiliated group as one corporation). For this purpose, the Committee intends that income from the active conduct of a securities business be determined in the manner provided in the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. Sec. 1.1296-6. Alternatively, if the corporation (and all members of the affiliated group of which it is a member) so elect, these exceptions for active financing income would not apply and the securities dealer exception to the dividend holding period requirement would apply without modification. For purposes

of these rules, an affiliated group is as defined under section 1504, but determined without regard to sec. 1504(b) (2) and (3).

Section 901(k) was enacted as part of the Taxpayer Relief Act of 1997 in order to eliminate implicit subsidies provided by the U.S. Treasury to U.S. taxpayers (including U.S. shareholders of CFCs) that generate low-tax foreign source income. The securities industry argued in connection with that legislation that the exception for securities dealers provided in section 901(k)(4) was necessary to alleviate the competitive tax disadvantage faced by U.S.-owned securities dealers because such dealers did not enjoy the same opportunity as foreign-owned competitors to defer home country tax on low-tax foreign income. For purposes of this provision, the Committee has adopted the coordination rule described above because the subpart F exceptions provided by the bill eliminate the primary factual premise for the section 901(k)(4) exception for securities dealers. However, the Committee believes that it would be appropriate to continue studying these competing concerns in order to determine whether this coordination rule adequately addresses those concerns or whether it should be modified in connection with any extension of the provision.

#### EFFECTIVE DATE

The provision applies only to the first full taxable year of a foreign corporation beginning in 1998, and to the taxable years of United States shareholders with or within which such taxable year of such foreign corporations ends.

#### B. TAX-FREE ROLLOVER OF GAIN ON SALE OF STOCK IN AGRICULTURAL PROCESSING FACILITIES TO CERTAIN FARMERS' COOPERATIVES

(sec. 2 of the bill and new sec. 1042A of the Code)

#### PRESENT LAW

There are no provisions under present law which permit the tax-free rollover of gain on the sale of stock in a processing or refining company to a farmers' cooperative.

However, if certain requirements are satisfied, a taxpayer may defer recognition of gain on the sale of qualified securities to an employee stock ownership plan ("ESOP") or an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property (sec. 1042). Gain is recognized when the taxpayer disposes of the qualified replacement property. One of the requirements that must be satisfied for deferral to apply is that, immediately after the sale, the ESOP must own at least 30 percent of the stock of the corporation issuing the qualified securities. In general, qualified securities are securities issued by a domestic C corporation that has no stock outstanding that is readily tradeable on an established securities market. Deferral treatment does not apply to gain on the sale of qualified securities by a C corporation.

## REASONS FOR CHANGE

*Background*

The Committee understands that much of the final value of farm products often is generated not in their production on the farm, but during the processing or refining of farm products after those products leave the farm. The Committee believes that, in order for farmers to share more of that final value, farmers must directly or indirectly own some of the processing or refining facilities. The Committee believes it appropriate to facilitate the transfer of refiners and processors to farmers' cooperatives.

The Taxpayer Relief Act of 1997 contained a provision (sec. 968 of the Act) that provided for the tax-free rollover of gain on the sale of stock of a corporation that owns farm product processing or refining facilities if the stock was sold to a cooperative which was selling farm produce for refining or processing in those facilities. However, the provision was canceled by the President under the recently enacted line-item veto legislation.

Nonetheless, the Committee continues to believe that it is appropriate to facilitate the transfer of refining and processing facilities to farmers' cooperatives. The Committee continues to believe that an appropriate way to facilitate such transfers is to provide for the tax-free rollover of gain on the sale of stock of a corporation that owns farm product processing and refining facilities, including restrictions that better target the benefit of the provision and address many of the concerns that caused the President to cancel the provision in the Taxpayer Relief Act of 1997.

Accordingly, the Committee bill will permit the tax-free rollover of gain on the sale of all (i.e., 100 percent) of the stock of a corporation that owns a processing facility to a cooperative which is engaged in marketing agricultural or horticultural products. The seller would have to reinvest the proceeds from the sale of the stock of the corporation owning the processing facilities in stock of an active C corporation other than stock of the selling corporation or any related person.

*Additional targeting provisions*

*Dollar cap.*—In order to better target the tax benefit of the tax-free rollover to smaller processing facilities, the Committee bill limits the maximum amount of gain that can qualify from the tax-free rollover with respect to the acquisition by an eligible farmers' cooperative in any taxable year to \$75 million.

*Prevention of conversion of deferral into exemption.*—In order to prevent the effective conversion of a deferral provision into an exemption, the Committee bill provides that the reinvestment of the sales proceeds by the seller not be in stock of the selling corporation or a related person.

*Relationship between cooperative and processing facilities (the "50-percent test").*—Because the purpose of the provision is to facilitate the acquisition of processing and refining facilities that process or refine products downstream of the cooperative, the Committee believes that the benefits of tax-free rollover should be provided only where more than half of the agricultural products processed or refined in the acquired processing facilities were purchased from

the cooperative or its members for an adequate period of time. The Committee believes that the effect of this rule should be to increase the portion of the tax benefit of the tax-free rollover that is passed through to the cooperative because only a sale to that particular cooperative will be eligible for the tax-free rollover.

The bill that the President canceled required that this 50-percent test be met only for the one year period prior to the sale of the processing corporation to the cooperative. The Committee now believes that the one-year period provided in the prior bill was insufficient and that this "50-percent test" generally should be met for the five-year periods both preceding and succeeding the sale of the stock of the processing corporation to the cooperative. Nonetheless, the Committee believes that determining whether a processing corporation meets this 50-percent test might prove burdensome in the case of small cooperatives (i.e., those cooperatives that never had gross receipts in excess of \$1 billion for any taxable year) or cooperatives that principally sold fungible commodities that are not "specialty produce" (i.e., agricultural or horticultural products other than wheat, feed grains, oil seeds, cotton, rice, cattle, hogs, sheep, or dairy products) which are more easily traced. Accordingly, the Committee bill provides that the 50-percent test be met for only the five-year period after their purchase by the cooperative in the case of small cooperatives and cooperatives that deal solely in nonspecialty produce.

*Retention of corporate tax on income of processor.*—Similarly, the Committee believes that the provision should insure that assets stay in corporate solution unless gain on those assets is recognized. Accordingly, the Committee bill provides that the liquidation of the corporation owning the processing facilities be ineligible for tax-free liquidation under section 332. Further, the provision would prevent a basis step-up without gain recognition by disallowing the application section 338(h)(10) to the acquiring cooperative.

*Recapture of tax benefit.*—In addition, in order to prevent the use of the provision to sell refining and processing facilities to a person other than a farmers' cooperative, the Committee bill provides that an excise tax is imposed on the cooperative if it sells or otherwise disposes of its interest in the processing or refining facilities within three years of its purchase of this interest.

#### EXPLANATION OF PROVISION

##### *In general*

The bill provides for the deferral of certain gains from the sale of "qualified agricultural processor stock" to an "eligible farmers' cooperative" to the extent that the taxpayers purchases "qualified replacement property" within the "replacement period." Deferral is available only if, immediately after the sale, the eligible farmers' cooperative owns 100 percent of the stock (other than certain preferred stock described in section 1504(a)(4)) and only to the extent that the eligible farmers' cooperative allocates a portion of its annual \$75 million limitation to the seller (i.e., the maximum aggregate amount that can be deferred by all sellers to a single cooperative in any taxable year of the cooperative may not exceed \$75 mil-

lion). For this purpose, all cooperatives which are under common control are treated as a single cooperative.

There is no limit on the number of qualified agricultural processors that a taxpayer can sell to an eligible farmers' cooperative or cooperatives in any one year or years to which tax-free rollover may apply. However, only gain that would be long-term capital gain may be deferred under this provision.

In order for gain to be deferred, the seller must have held the stock of the qualified agricultural processor for three years prior to its sale and the cooperative to whom the qualified agricultural processor is sold must consent to the imposition of a tax on all or a portion of the deferred gain if there is a subsequent "recapture event." No election to defer gain under this provision may be made if an election to defer gain had been made with respect to the sale under section 1042. The provision does not apply if the seller is an eligible farmers' cooperative.

#### *Qualified agricultural processor stock*

In general, stock is qualified agricultural processor stock if it is stock (other than certain preferred stock described in section 1504(a)(4)) issued by a qualified agricultural processor. A qualified agricultural processor is a domestic C corporation substantially all of the assets of which are used in the active conduct of the trade or business of refining or processing agricultural or horticultural products in the United States. Stock in a processor may be qualified agricultural processor stock even if the stock of the qualified agricultural processor is publicly traded and even if all of the products refined or processed within the United States were products grown or raised outside the United States.

#### *Eligible farmers' cooperative*

An eligible farmers' cooperative is an organization which is treated as a cooperative for Federal income tax purposes (whether or not such cooperative is described in section 521) and which is engaged in the marketing of agricultural or horticultural products.

#### *50-percent test*

In order for the sale of qualified agricultural processor stock to certain eligible farmers' cooperatives to be eligible for the tax-free rollover, the processor must meet a 50-percent test. In general, a processor meets the 50-percent test if more than 50 percent of the agricultural or horticultural products to be refined or processed by the qualified agricultural processor were purchased from the eligible farmers' cooperative that is purchasing the qualified agricultural processor, or from members of that cooperative, for at least three of the five taxable years of the processor ending on or before the date of the purchase of the qualified agricultural processor by the eligible farmers' cooperative. For this purpose, purchases by the processor from intermediary owners of agricultural commodities may be counted as a purchase from a cooperative or its members if written evidence is available that the commodities were transferred from the cooperative or its members to the intermediary which transferred such commodities to the processor or another

intermediary or intermediaries who ultimately transferred those commodities to the processor.

Cooperatives required to meet this 50-percent test are (1) any cooperative or any predecessor (and any related person under sections 52(a), 52(b), 414(m), or 414(o)) who had gross receipts of more than \$1 billion for any taxable year preceding the purchase of qualified agricultural processor stock or (2) any cooperative that sold more than a de minimis amount of specialty produce. For purposes of the first rule, the sales of predecessors of the cooperative are to be taken into account, but gross receipts exclude sales returns and allowances. If any year is a short year, the amount of the gross receipts for those years is annualized. For purposes of the second rule, specialty produce is any agricultural or horticultural product other than wheat, feed grains, oil seeds, cotton, rice, cattle, hogs, sheep, or dairy products.

*Qualified reinvestment property*

Gain on the sale of processor stock to a cooperative is not recognized only to the extent that the proceeds from the sale of the processor stock are invested in securities of an active C corporation. Qualified reinvestment property may not be securities of the selling corporation or any corporation in which the selling corporation owns 10 percent (applying the principles of section 304(c)) of the stock of that selling corporation. Qualified reinvestment property also does not include securities in the qualified agricultural processor.

The basis of any qualified reinvestment property is reduced by any gain that is not recognized by reason of this provision. Thus, any deferred gain will be recognized when the seller disposes of the reinvestment property, other than in dispositions which are part of a reorganization, dispositions at death, gift, or divorce.

*Reinvestment period*

The seller would have to reinvest the proceeds from the sale of the stock of the corporation owning the processing facilities within a period beginning 3 months before and ending one year after such sale.

*Special rules applicable to qualified agricultural processor*

The liquidation of a qualified refiner or processor into a cooperative is not tax-exempt under section 332 if the cooperative acquired the qualified refiner or processor in a transaction on which gain had been deferred under this provision. Section 338(h)(10) shall not apply to the acquisition of a qualified refiner or processor if the cooperative acquires the qualified refiner or processor in a transaction on which gain had been deferred under this provision.

*Recapture tax on dispositions, etc., of qualified agricultural processor*

*General rule.*—If there is a “recapture event” with respect to an eligible farmers’ cooperative during a taxable year, a tax is imposed on the eligible farmers’ cooperative equal to the highest corporate tax rate multiplied by the “recapture percentage” of any gain which

was allocated to the seller of the stock in the qualified agricultural processor.

*Recapture event.*—A recapture event is either one or both of the following events:

(1) A decrease, within the three year period subsequent to the acquisition of the processor by the cooperative, in the percentage of the stock in the processor that is owned, directly or indirectly, by the cooperative; or

(2) The failure, in any three of the five taxable years following the acquisition of the processor by the cooperative, of the cooperative to purchase more than one-half of the agricultural or horticultural products which it processes or refines from the cooperative or its members.

A decrease described in (1) above can occur, for example, if (a) the cooperative sells some or all of its stock in the processor or (b) the processor issues more stock to someone other than the cooperative.

*Recapture percentage.*—The recapture percentage is the percentage by which the ownership by the eligible farmers' cooperative in the eligible agricultural processor which qualified for the tax-free rollover decreases. Where the recapture event is a failure to meet the 50-percent test (described in (2), above), the recapture percentage is 100 percent.

*Exception for failure to meet 50-percent test because of uncontrollable circumstances.*—No recapture tax is imposed if the Treasury Secretary determines that the failure of the processor to meet the 50-percent test is due to flood, drought, other weather-related conditions, environmental contamination, disease, fire, or similar extenuating circumstances prescribed by the Treasury Secretary.

#### *Treasury regulations*

The bill directs that the Secretary of the Treasury issue regulations that are appropriate to carry out the purposes of this provision, including regulations treating two or more sales which are part of the same transaction as a single sale.

#### EFFECTIVE DATE

The provision applies to sales after December 31, 1997.

### III. VOTE OF THE COMMITTEE

In compliance with clause 2(1)(2)(B) of rule XI of the Rules of the House of Representatives, the following statement is made concerning the vote on the motion to report the bill. The bill (H.R. 2513) was ordered favorably reported, as amended by voice vote on September 23, 1997, with a quorum present.

### IV. BUDGET EFFECTS OF THE BILL

#### A. COMMITTEE ESTIMATES

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the estimated budget effects of the bill as reported.

The bill, as reported, is estimated to have the following effect on the budget:

ESTIMATED BUDGET EFFECTS OF H.R. 2513 AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS ON SEPTEMBER 23, 1997 TO RESTORE AND MODIFY PROVISIONS  
 IN THE "TAXPAYER RELIEF ACT OF 1997" CANCELLED PURSUANT TO THE LINE ITEM VETO ACT—FISCAL YEARS 1998–2007

[In millions of dollars]

Provision	Effective											
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
1. Exemption from subpart F for certain active financing income (section 1) ..... tybi 1998	-14	-41	-2	.....	.....	.....	.....	.....	.....	.....	-57	-57
2. Deferral of gain on sales of stock in farm product refining firms to farm sea 12/31/97	-1	-3	-4	-4	-4	-4	-4	-4	-4	-4	-4	-34
coops which supply the firm with raw farm products for refining (section 2).												
<b>Net total</b> .....	-15	-44	-6	-4	-4	-4	-4	-4	-4	-4	-72	-91

Note. Details may not add to totals due to rounding.

Legend for "Effective" column: sea=sales or exchanges after; tybi=taxable years beginning in.

The Joint Committee on Taxation estimates that the bill as reported would lose \$72 million over the 5-year period, fiscal years 1998–2002. However, the bill includes language stating that it should be treated as if it had been part of the Taxpayer Relief Act of 1997. Therefore, it should not trigger a sequester under Pay-go procedures.

## B. BUDGET AUTHORITY AND TAX EXPENDITURES

### BUDGET AUTHORITY

In compliance with subdivision (B) of clause 2(1)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions of the bill as reported involve no new or increased budget authority.

### TAX EXPENDITURES

In compliance with subdivision (B) of clause 2(1)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions of the bill as reported involve increased tax expenditures in the amounts shown in the revenue table in IV.A., above.

## C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with subdivision (C) of clause 2(1)(3) of rule XI of the Rules of the House of Representatives, requiring cost estimate prepared by the Congressional Budget Office, the Committee advises that the Congressional Budget Office has submitted the following statement on this bill.

U.S. CONGRESS,  
CONGRESSIONAL BUDGET OFFICE,  
*Washington, DC, September 30, 1997.*

Hon. BILL ARCHER,  
*Chairman, Committee on Ways and Means,  
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed H.R. 2513, which would amend the Internal Revenue Code of 1986 to restore in a modified form two provisions in the Taxpayer Relief Act of 1997 that were canceled by the President pursuant to the Line Item Veto Act. The provisions would exempt active financing income from foreign personal holding company income and provide for the nonrecognition of gain on the sale of stock in agricultural processors to certain farmers' cooperatives.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Alyssa Treszkowski.

Sincerely,

JUNE E. O'NEILL, *Director.*

Enclosure.

*H.R. 2513—To amend the Internal Revenue Code of 1986 to restore and modify the provision of the Taxpayer Relief Act of 1997 relating to exempting active financing income from foreign personal holding company income and to provide for the non-recognition of gain on the sale of stock in agricultural processors to certain farmers’ cooperatives.*

Summary: H.R. 2513 would restore in a modified form two provisions in the Taxpayer Relief Act of 1997 that were canceled by the President pursuant to the Line Item Veto Act. The first provision amends the Internal Revenue Code to restore the exemption of active financing income from foreign personal holding income. The second provision amends the Internal Revenue Code to provide for the deferral of gain on the sale of stock in agricultural processors to certain farmers’ cooperatives. The Joint Committee on Taxation (JCT) estimates that enacting this bill would reduce governmental receipts by \$72 million over the 1998–2002 period. Because enacting this bill would affect receipts, pay-as-you-go procedures ordinarily would apply to the bill. However, the legislation contains a provision that directs the Director of the Office of Management and Budget to exclude the effects of this legislation from the pay-as-you-go procedures.

H.R. 2513 contains no new private-sector or intergovernmental mandates as defined in the Unfunded Mandates Reform Act of 1995 (UMRA) and would not impose any costs on state, local, or tribal governments.

Estimated cost to the Federal Government: The estimated budgetary impact of H.R. 2513 is shown in the attached JCT table.

Direct spending and receipt effects: Section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985 sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. CBO’s estimate of the effects of H.R. 2513 on direct spending and receipts are summarized below, but section 2(d) of the bill directs the Director of the Office of Management and Budget to exclude these effects from the pay-as-you-go procedures.

DIRECT SPENDING AND RECEIPT EFFECTS

[By fiscal year, in billions of dollars]

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Changes in outlays .....										
Changes in receipts .....	-15	-44	-6	-4	-4	-4	-4	-4	-4	-4

Intergovernmental and private-sector impact: The bill contains no new private-sector or intergovernmental mandates as defined in UMRA and would not impose any costs on state, tribal, or local governments.

Estimate prepared by: Alyssa Trzeszkowski.

Estimate approved by: Rosemary Marcuss, Assistant Director for Tax Analysis.

## **V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE**

### A. COMMITTEE OVERSIGHT FINDINGS AND RECOMMENDATIONS

With respect to subdivision (A) of clause 2(1)(3) of rule XI of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was the result of the Committee's oversight activities concerning the application of provisions in the Taxpayer Relief Act of 1997 that were canceled by the President's line item veto relating to exceptions under subpart F for certain active financing income and nonrecognition of gain on the sale of stock in agricultural processors to certain farmers' cooperatives that the Committee concluded that it is appropriate to enact the provisions contained in the bill as reported.

### B. SUMMARY OF FINDINGS AND RECOMMENDATIONS OF THE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

With respect to subdivision (D) of clause 2(1)(3) of rule XI of the Rules of the House of Representatives, the Committee advises that no oversight findings or recommendations have been submitted to this Committee by the Committee on Government Reform and Oversight with respect to the provisions contained in the bill.

### C. CONSTITUTIONAL AUTHORITY STATEMENT

With respect to clause 2(1)(4) of rule XI of the Rules of the House of Representatives (relating to Constitutional Authority), the Committee states that the Committee's action in reporting this bill is derived from Article I of the Constitution, Section 7 ("All bills for raising revenue shall originate in the House of Representatives") and Section 8 ("The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts . . . of the United States"), and from the 16th Amendment to the Constitution.

### D. INFORMATION RELATING TO UNFUNDED MANDATES

This information is provided in accordance with section 423 of the Unfunded Mandates Act of 1995 (P.L. 104-4).

The Committee has determined that the provisions of the bill do not impose a Federal mandate on the private sector nor a Federal intergovernmental mandate. Thus, the provisions of the bill do not affect the competitive balance between the private sector and State, local, and tribal governments.

### E. APPLICABILITY OF HOUSE RULE XXI5(C)

Rule XXI5(c) of the Rules of the House of Representatives provides, in part, that "No bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase shall be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members." The Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not involve any Federal income tax rate increase within the meaning of the rule.

**VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED**

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman).

**INTERNAL REVENUE CODE OF 1986**

\* \* \* \* \*

**Subtitle A—Income Taxes**

\* \* \* \* \*

**CHAPTER 1—NORMAL TAXES AND SURTAXES**

\* \* \* \* \*

**PART IV—CREDITS AGAINST TAX**

\* \* \* \* \*

**Subpart A—Nonrefundable Personal Credits**

\* \* \* \* \*

**SEC. 26. LIMITATION BASED ON TAX LIABILITY; DEFINITION OF TAX LIABILITY.**

(a) \* \* \*

(b) **REGULAR TAX LIABILITY.**—For purposes of this part—

(1) **IN GENERAL.**—The term “regular tax liability” means the tax imposed by this chapter for the taxable year.

(2) **EXCEPTION FOR CERTAIN TAXES.**—For purposes of paragraph (1), any tax imposed by any of the following provisions shall not be treated as tax imposed by this chapter:

(A) \* \* \*

\* \* \* \* \*

(O) sections 453(l)(3) and 453A(c) (relating to interest on certain deferred tax liabilities),

(P) section 860K (relating to treatment of transfers of high-yield interests to disqualified holders), **[and]**

(Q) section 220(f)(4) (relating to additional tax on medical savings account distributions not used for qualified medical expenses) **[.], and**

(R) *section 1042A(f) (relating to recapture of tax benefit where lack of continuity in certain agricultural processors).*

\* \* \* \* \*

**PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES**

\* \* \* \* \*

**Subpart F—Controlled Foreign Corporations**

\* \* \* \* \*

**SEC. 954. FOREIGN BASE COMPANY INCOME.**

(a) \* \* \*

\* \* \* \* \*

(c) **FOREIGN PERSONAL HOLDING COMPANY INCOME.—**

(1) \* \* \*

(2) **EXCEPTION FOR CERTAIN AMOUNTS.—**

(A) \* \* \*

\* \* \* \* \*

**[(C) EXCEPTION FOR DEALERS.—**Except as provided in subparagraph (A), (E), or (G) of paragraph (1) or by regulations, in the case of a regular dealer in property (within the meaning of paragraph (1)(B)), forward contracts, option contracts, or similar financial instruments (including notional principal contracts and all instruments referenced to commodities), there shall not be taken into account in computing foreign personal holding income any item of income, gain, deduction, or loss from any transaction (including hedging transactions) entered into in the ordinary course of such dealer's trade or business as such a dealer.]

*(C) EXCEPTION FOR DEALERS.—Except as provided by regulations, in the case of a regular dealer in property (within the meaning of paragraph (1)(B)), forward contracts, option contracts, or similar financial instruments (including notional principal contracts and all instruments referenced to commodities), there shall not be taken into account in computing foreign personal holding income—*

*(i) any item of income, gain, deduction, or loss (other than any item described in subparagraph (A), (E), or (G) of paragraph (1)) from any transaction (including hedging transactions) entered into in the ordinary course of such dealer's trade or business as such a dealer, and*

*(ii) if such dealer is a dealer in securities (within the meaning of section 475), any interest or dividend or equivalent amount described in subparagraph (E) or (G) of paragraph (1) from any transaction (including any hedging transaction or transaction described in section 956(c)(2)(J)) entered into in the ordinary course of such dealer's trade or business as such a dealer in securities, but only if employees of the dealer which are located in the country under the laws of which the dealer is created or organized (or in the case of a qualified business unit described in section 989(a) which both maintains its principal office and conducts substantial business activity in a country, employees of such unit which are located in such country) materially participate in such transaction.*

\* \* \* \* \*

(e) **FOREIGN BASE COMPANY SERVICES INCOME.—**

(1) \* \* \*

(2) EXCEPTION.—Paragraph (1) shall not apply to income derived in connection with the performance of services which are directly related to—

(A) the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and which are performed before the time of the sale or exchange, **[or]**

(B) an offer or effort to sell or exchange such property~~].~~, or

(C)(i) a transaction by the controlled foreign corporation if the income from the transaction is not foreign personal holding company income by reason of subsection (h), or

(ii) a transaction by the controlled foreign corporation if subsection (c)(2)(C)(ii) applies to such transaction.

\* \* \* \* \*

(h) SPECIAL RULE FOR INCOME DERIVED IN THE ACTIVE CONDUCT OF INSURANCE BUSINESSES AND BANKING, FINANCING, OR SIMILAR BUSINESSES.—

(1) IN GENERAL.—For purposes of subsection (c)(1), foreign personal holding company income shall not include income which is—

(A) derived in the active conduct by a controlled foreign corporation of a banking, financing, or similar business, but only if—

(i) the corporation is predominantly engaged in the active conduct of such business, and

(ii) such income is derived from transactions with customers located within the country under the laws of which the corporation is created or organized,

(B) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from the investments made by a qualifying insurance company of its reserves or of 80 percent of its unearned premiums (as both are determined in the manner prescribed under paragraph (4)), or

(C) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from investments made by a qualifying insurance company of an amount of its assets equal to—

(i) in the case of property, casualty, or health insurance contracts, one-third of its premiums earned on such insurance contracts during the taxable year (as defined in section 832(b)(4)), and

(ii) in the case of life insurance or annuity contracts, 10 percent of the reserves described in subparagraph (B) for such contracts.

(2) PREDOMINANTLY ENGAGED.—For purposes of paragraph (1)(A), a controlled foreign corporation shall be deemed predominantly engaged in the active conduct of a banking, financing, or similar business only if—

(A) more than 70 percent of its gross income is derived from such business from transactions with customers which

are located within the country under the laws of which the corporation is created or organized, or

(B) the corporation is—

(i) engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified by the Secretary in regulations), or

(ii) engaged in the active conduct of a securities business and is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934 or is registered as a Government securities broker or dealer under section 15C(a) of such Act (or is any other corporation not so registered which is specified by the Secretary in regulations).

(3) **PRINCIPLES FOR DETERMINING INSURANCE INCOME.**—Except as provided by the Secretary, for purposes of paragraphs (1) (B) and (C)—

(A) in the case of any contract which is a separate account-type contract (including any variable contract not meeting the requirements of section 817), income credited under such contract shall be allocable only to such contract, and

(B) income not allocable under subparagraph (A) shall be allocated ratably among contracts not described in subparagraph (A).

(4) **METHODS FOR DETERMINING UNEARNED PREMIUMS AND RESERVES.**—For purposes of paragraph (1)(B)—

(A) **PROPERTY AND CASUALTY CONTRACTS.**—The unearned premiums and reserves of a qualifying insurance company with respect to property, casualty, or health insurance contracts shall be determined using the same methods and interest rates which would be used if such company were subject to tax under subchapter L.

(B) **LIFE INSURANCE AND ANNUITY CONTRACTS.**—The amount of the reserve of a qualifying insurance company for any life insurance or annuity contract shall be equal to the greater of—

(i) the net surrender value of such contract (as defined in section 807(e)(1)(A)), or

(ii) the reserve determined under paragraph (5).

(C) **LIMITATION ON RESERVES.**—In no event shall the reserve determined under this paragraph for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining foreign statement reserves (less any catastrophe, deficiency, or similar reserves).

(5) **AMOUNT OF RESERVE.**—The amount of the reserve determined under this paragraph with respect to any contract shall be determined in the same manner as it would be determined if the qualifying insurance company were subject to tax under subchapter L, except that in applying such subchapter—

(A) the interest rate determined for the foreign country in which such company is created or organized and which, ex-

cept as provided by the Secretary, is calculated in the same manner as the Federal mid-term rate under section 1274(d) shall be substituted for the applicable Federal interest rate,

(B) the highest assumed interest rate permitted to be used in determining foreign statement reserves shall be substituted for the prevailing State assumed interest rate, and

(C) tables for mortality and morbidity which reasonably reflect the current mortality and morbidity risks in the foreign country shall be substituted for the mortality and morbidity tables otherwise used for such subchapter.

(6) DEFINITIONS.—For purposes of this subsection—

(A) QUALIFYING INSURANCE COMPANY.—The term “qualifying insurance company” means any entity which—

(i) is subject to regulation as an insurance company by the country under the laws of which the entity is created or organized,

(ii) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks located within such country, and

(iii) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

(B) LIFE INSURANCE OR ANNUITY CONTRACT.—For purposes of this section and section 953, the determination of whether a contract issued by a controlled foreign corporation is a life insurance contract or an annuity contract shall be made without regard to sections 72(s), 101(f), 817(h), and 7702 if—

(i) such contract is regulated as a life insurance or annuity contract by the country under the laws of which the corporation is created or organized, and

(ii) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.

(C) NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—A noncancellable accident and health insurance contract shall be treated for purposes of this subsection in the same manner as a life insurance contract except that paragraph (4)(B)(i) shall not apply.

(D) LOCATED.—

(i) IN GENERAL.—The determination of where a customer is located shall be made under rules prescribed by the Secretary.

(ii) SPECIAL RULE FOR QUALIFIED BUSINESS UNITS.—Gross income derived by a corporation’s qualified business unit (within the meaning of section 989(a)) from transactions with customers which are located in the country in which the qualified business unit both maintains its principal office and conducts substantial business activity shall be treated as derived from transactions with customers which are located within the country under the laws of which the controlled foreign corporation is created or organized.

(E) CUSTOMER.—

(i) *IN GENERAL.*—The term “customer” means, with respect to any controlled foreign corporation, any person which has a customer relationship with such corporation.

(ii) *EXCEPTION FOR RELATED, ETC. PERSONS.*—A person who is a related person (as defined in subsection (d)(3)), an officer, a director, or an employee with respect to any controlled foreign corporation shall not be treated as a customer with respect to any transaction if a principal purpose of such transaction is to satisfy any requirement of this subsection.

(7) *ANTI-ABUSE RULES.*—For purposes of applying this subsection and subsection (c)(2)(C)(ii), there shall be disregarded any item of income, gain, loss, or deduction with respect to any transaction or series of transactions one of the principal purposes of which is qualifying income or gain for the exclusion under this section, including—

(A) any change in the method of computing reserves or any other transaction or series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of such exclusion through the application of this subsection, and

(B) organizing entities in order to satisfy any same country requirement under this subsection.

(8) *COORDINATION WITH OTHER PROVISIONS.*—

(A) *SECTION 901(k).*—

(i) *IN GENERAL.*—The amount of qualified taxes (as defined in section 901(k)(4) to which paragraphs (1) and (2) of section 901(k) do not apply by reason of paragraph (4) of such section 901(k) shall be reduced by an amount which bears the same ratio to such qualified taxes as the amount of income from the active conduct of a securities business which is not subpart F income solely by reason of this subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) bears to the total income from the active conduct of a securities business by a controlled foreign corporation which is not subpart F income. The determination under the preceding sentence shall be made by treating all members of an affiliated group as 1 corporation. For purposes of this clause, the term “subpart F income” has the meaning given such term by section 952(a) but determined without regard to section 952(c) and paragraphs (3) and (4) of subsection (b) of this section.

(ii) *ELECTION NOT TO HAVE SUBSECTION AND CERTAIN OTHER PROVISIONS APPLY.*—Clause (i) shall not apply for any taxable year of a foreign corporation if such corporation (and all members of the affiliated group of which such corporation is a member) elect not to have this subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) apply for such taxable year.

(B) *TREATMENT OF INCOME TO WHICH SECTION 953 APPLIES.*—Subparagraphs (B) and (C) of paragraph (1) shall not apply to investment income allocable to contracts that

*insure related party risks or risks located in a foreign country other than the country in which the qualifying insurance company is created or organized.*

*(9) APPLICATION.—This subsection, subsection (c)(2)(C)(ii), and subsection (e)(2)(C) shall apply only to the first full taxable year of a foreign corporation beginning after December 31, 1997, and before January 1, 1999, and to taxable years of United States shareholders with or within which such taxable year of such foreign corporation ends.*

\* \* \* \* \*

## Subchapter O—Gain or Loss on Disposition of Property

\* \* \* \* \*

### PART III—COMMON NONTAXABLE EXCHANGES

Sec. 1031. Exchange of property held for productive use or investment.

\* \* \* \* \*

Sec. 1042A. Sales of stock to certain farmers' cooperatives.

\* \* \* \* \*

#### **SEC. 1042A. SALES OF STOCK TO CERTAIN FARMERS' COOPERATIVES.**

*(a) NONRECOGNITION OF GAIN.—If—*

*(1) the taxpayer elects the application of this section with respect to any sale of qualified agricultural processor stock,*

*(2) the taxpayer purchases qualified replacement property within the replacement period, and*

*(3) the requirements of subsection (c) are met with respect to such sale,*

*then the gain (if any) on such sale which would be recognized as long-term capital gain shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property. The preceding sentence shall not apply to a sale by an eligible farmers' cooperative.*

*(b) LIMITATION.—*

*(1) IN GENERAL.—If subsection (a) applies to the sale of any stock by the taxpayer in a qualified agricultural processor, the aggregate amount of gain taken into account by the taxpayer under subsection (a) with respect to stock in such processor shall not exceed the amount of the limitation under paragraph (2) which is allocated to such sale by the eligible farmers' cooperative.*

*(2) ALLOCATION.—The amount allocated under this paragraph by any cooperative with respect to stock acquired by such cooperative during any taxable year of such cooperative shall not exceed \$75,000,000.*

*(3) AGGREGATION RULES.—All eligible farmers' cooperatives which are under common control (within the meaning of subsection (a) or (b) of section 52) shall be treated as 1 cooperative for purposes of paragraph (2), and the limitation under such*

paragraph shall be allocated among such cooperatives in such manner as the Secretary shall prescribe.

(c) **REQUIREMENTS TO QUALIFY FOR NONRECOGNITION.**—A sale of qualified agricultural processor stock meets the requirements of this subsection if—

(1) **SALE TO ELIGIBLE FARMERS' COOPERATIVE.**—Such stock is sold to an eligible farmers' cooperative.

(2) **SPECIAL RULE FOR CERTAIN COOPERATIVES.**—

(A) **IN GENERAL.**—In the case of a sale of such stock to an eligible farmers' cooperative described in subparagraph (B), the processor purchased, during at least 3 of the 5 most recent taxable years of such processor ending on or before the date of the sale, more than one-half of the agricultural or horticultural products to be refined or processed by such processor from such cooperative or farmers who are members of such cooperative.

(B) **COOPERATIVES DESCRIBED.**—A cooperative is described in this subparagraph with respect to any sale if, for any taxable year ending before the date of such sale—

(i) such cooperative had gross receipts of more than \$1,000,000,000, or

(ii) such cooperative sold more than a de minimis amount of specialty produce.

(C) **SPECIALTY PRODUCE.**—For purposes of subparagraph (B), the term “specialty produce” means any agricultural or horticultural product other than wheat, feed grains, oil seeds, cotton, rice, cattle, hogs, sheep, or dairy products.

(D) **SPECIAL RULES.**—

(i) **GROSS RECEIPTS.**—For purposes of subparagraph (B)(i), rules similar to the rules of paragraph (2), and subparagraphs (B) and (C) of paragraph (3), of section 448(c) shall apply.

(ii) **PREDECESSOR.**—Any reference in this paragraph to a cooperative or processor shall be treated as including a reference to any predecessor thereof.

(3) **COOPERATIVE MUST HOLD 100 PERCENT OF STOCK AFTER SALE.**—The eligible farmers' cooperative owns, immediately after the sale, all of the qualified agricultural processor stock of the corporation.

(4) **WRITTEN STATEMENT AND HOLDING PERIOD.**—Requirements similar to the requirements of paragraphs (3) and (4) of section 1042(b) are met.

(d) **DEFINITIONS.**—For purposes of this section—

(1) **QUALIFIED AGRICULTURAL PROCESSOR STOCK.**—The term “qualified agricultural processor stock” means stock (other than stock described in section 1504(a)(4)) issued by a qualified agricultural processor.

(2) **QUALIFIED AGRICULTURAL PROCESSOR.**—The term “qualified agricultural processor” means a domestic C corporation substantially all of the assets of which are used in the active conduct of the trade or business of refining or processing agricultural or horticultural products in the United States.

(3) **ELIGIBLE FARMERS' COOPERATIVE.**—The term “eligible farmers' cooperative” means an organization to which part I of

subchapter T applies and which is engaged in the marketing of agricultural or horticultural products.

(4) *REPLACEMENT PERIOD.*—The term “replacement period” means the period which begins 3 months before the date on which the sale of qualified agricultural processor stock occurs and which ends 12 months after the date of such sale.

(5) *QUALIFIED REPLACEMENT PROPERTY.*—

(A) *IN GENERAL.*—Except as provided in subparagraph (B), the term “qualified replacement property” has the meaning given such term by section 1042(c)(4).

(B) *EXCEPTION.*—The term “qualified replacement property” shall not include any security issued by the taxpayer or by any corporation controlled by the taxpayer immediately after the purchase. For purposes of the preceding sentence, the term “control” has the meaning given such term by section 304(c) (determined by substituting “10 percent” for “50 percent” each place it appears in paragraph (1) thereof).

(e) *SPECIAL RULES.*—

(1) *IN GENERAL.*—Except as otherwise provided in this subsection, rules similar to the rules of paragraphs (5) and (6) of section 1042(c), subsections (d), (e), and (f) of section 1042, section 1016(a)(22), and section 1223(13) shall apply for purposes of this section.

(2) *CERTAIN PROVISIONS NOT TO APPLY.*—

(A) *RECOGNITION ON COMPLETE LIQUIDATION.*—Section 332 shall not apply to the liquidation into the cooperative or any related person of a qualified agricultural processor if the cooperative or related person acquired the stock in such processor in a sale to which subsection (a) applied.

(B) *DEEMED SALE ELECTION NOT AVAILABLE.*—No election may be made under section 338(h)(10) with respect to a sale to which subsection (a) applies.

(f) *RECAPTURE OF TAX BENEFIT WHERE LACK OF CONTINUITY.*—

(1) *IN GENERAL.*—If there is a recapture event during any taxable year with respect to any sale to an eligible farmers’ cooperative to which this section applied, such cooperative’s tax imposed by this chapter for such taxable year shall be increased by an amount equal to—

(A) the recapture percentage of the amount allocated under subsection (b) to such sale, multiplied by

(B) the highest rate of tax imposed by section 11 for such taxable year.

(2) *RECAPTURE EVENT.*—For purposes of this subsection, a recapture event shall be treated as occurring in any taxable year if—

(A) any portion of such taxable year is within the 3-year period beginning on the date on which the eligible farmers’ cooperative acquired stock in a qualified agricultural processor in a sale to which this section applied and, as of the close of such portion, there is a decrease in the direct or indirect percentage ownership of such stock held by such cooperative which was not previously taken into account under this subsection, or

(B) such taxable year is one of the first 5 taxable years ending after the date of such sale and is the third of such taxable years during which one-half or less of the agricultural or horticultural products refined or processed by the qualified agricultural processor are purchased from the eligible farmers' cooperative or farmers who are members of such cooperative.

(3) **RECAPTURE PERCENTAGE.**—For purposes of this subsection, the term “recapture percentage” means—

(A) in the case of a recapture event described in paragraph (2)(A), the percentage equal to a fraction—

(i) the numerator of which is the percentage decrease described in paragraph (2)(A), and

(ii) the denominator of which is the percentage which the qualified agricultural processor stock acquired by the cooperative in a sale to which this section applied bears to all qualified agricultural processor stock in the processor, and

(B) in the case of a recapture event described in paragraph (2)(B), 100 percent.

In no event shall the recapture percentage for any taxable year exceed 100 percent minus the sum of the recapture percentages for all prior taxable years.

(4) **EXCEPTIONS TO PURCHASE REQUIREMENT.**—The purchase requirement of paragraph (2)(B) shall be treated as met for any taxable year if the Secretary determines that such requirement was not met due to 1 or more of the following: flood, drought, or other weather-related conditions, environmental contamination, disease, fire, or other similar extenuating circumstances prescribed by the Secretary.

(g) **COORDINATION WITH SECTION 1042.**—No election may be made under this section with respect to any sale if an election is made under section 1042 with respect to such sale.

(h) **REGULATIONS.**—The Secretary shall prescribe such regulations as are appropriate to carry out this section, including regulations which treat 2 or more sales which are part of the same transaction as 1 sale.

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## SECTION 1175 OF THE TAXPAYER RELIEF ACT OF 1997

### **[SEC. 1175. EXEMPTION FOR ACTIVE FINANCING INCOME.**

**[(a) EXEMPTION FROM FOREIGN PERSONAL HOLDING COMPANY INCOME.**—Section 954 is amended by adding at the end the following new subsection:

**[(h) SPECIAL RULE FOR INCOME DERIVED IN THE ACTIVE CONDUCT OF BANKING, FINANCING, OR SIMILAR BUSINESSES.**—

**[(1) IN GENERAL.**—For purposes of subsection (c)(1), foreign personal holding company income shall not include income which is—

**[(A) derived in the active conduct by a controlled foreign corporation of a banking, financing, or similar business, but only if the corporation is predominantly engaged in the active conduct of such business,**

【“(B) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from the investments made by a qualifying insurance company of its reserves or of 80 percent of its unearned premiums (as both are determined in the manner prescribed under paragraph (4)), or

【“(C) received from a person other than a related person (within the meaning of subsection (d)(3)) and derived from investments made by a qualifying insurance company of an amount of its assets equal to—

【“(i) in the case of contracts regulated in the country in which sold as property, casualty, or health insurance contracts, one-third of its premiums earned on such insurance contracts during the taxable year (as defined in section 832(b)(4)), and

【“(ii) in the case of contracts regulated in the country in which sold as life insurance or annuity contracts, the greater of—

【“(I) 10 percent of the reserves described in subparagraph (B) for such contracts, or

【“(II) in the case of a qualifying insurance company which is a start-up company, \$10,000,000.

【“(2) PRINCIPLES FOR DETERMINING APPLICABLE INCOME.—

【“(A) BANKING AND FINANCING INCOME.—The determination as to whether income is described in paragraph (1)(A) shall be made—

【“(i) except as provided in clause (ii), in accordance with the applicable principles of section 904(d)(2)(C)(ii), except that such income shall include income from all leases entered into in the ordinary course of the active conduct of a banking, financing, or similar business, and

【“(ii) in the case of a corporation described in paragraph (3)(B), in accordance with the applicable principles of section 1296(b) (as in effect on the day before the enactment of the Taxpayer Relief Act of 1997) for determining what is not passive income.

【“(B) INSURANCE INCOME.—Under rules prescribed by the Secretary, for purposes of paragraphs (1) (B) and (C)—

【“(i) in the case of contracts which are separate account-type contracts (including variable contracts not meeting the requirements of section 817), only income specifically allocable to such contracts shall be taken into account, and

【“(ii) in the case of other contracts, income not allocable under clause (i) shall be allocated ratably among such contracts.

【“(C) LOOK-THRU RULES.—The Secretary shall prescribe regulations consistent with the principles of section 904(d)(3) which provide that dividends, interest, income equivalent to interest, rents, or royalties received or accrued from a related person (within the meaning of subsection (d)(3)) shall be subject to look-thru treatment for purposes of this subsection.

【“(3) PREDOMINANTLY ENGAGED.—For purposes of paragraph (1)(A), a corporation shall be deemed predominantly engaged in the active conduct of a banking, financing, or similar business only if—

【“(A) more than 70 percent of its gross income is derived from such business from transactions with persons which are not related persons (as defined in subsection (d)(3)) and which are located within the country under the laws of which the controlled foreign corporation is created or organized, or

【“(B) the corporation is—

【“(i) engaged in the active conduct of a banking or securities business (within the meaning of section 1296(b), as in effect before the enactment of the Taxpayer Relief Act of 1997), or

【“(ii) a qualified bank affiliate or a qualified securities affiliate (within the meaning of the proposed regulations under such section 1296(b)).

【“(4) METHODS FOR DETERMINING UNEARNED PREMIUMS AND RESERVES.—For purposes of paragraph (1)(B)—

【“(A) PROPERTY AND CASUALTY CONTRACTS.—The unearned premiums and reserves of a qualifying insurance company with respect to property, casualty, or health insurance contracts shall be determined using the same methods and interest rates which would be used if such company were subject to tax under subchapter L.

【“(B) LIFE INSURANCE AND ANNUITY CONTRACTS.—The reserves of a qualifying insurance company with respect to life insurance or annuity contracts shall be determined under the method described in paragraph (5) which such company elects to apply for purposes of this paragraph. Such election shall be made at such time and in such manner as the Secretary may prescribe and, once made, shall be irrevocable without the consent of the Secretary.

【“(C) LIMITATION ON RESERVES.—In no event shall the reserve determined under this paragraph for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining foreign annual statement reserves (less any catastrophe or deficiency reserves).

【“(5) METHODS.—The methods described in this paragraph are as follows:

【“(A) U.S. METHOD.—The method which would apply if the qualifying insurance company were subject to tax under subchapter L, except that the interest rate used shall be an interest rate determined for the foreign country in which such company is created or organized and which is calculated in the same manner as the Federal mid-term rate under section 1274(d).

【“(B) FOREIGN METHOD.—A preliminary term method, except that the interest rate used shall be the interest rate determined for the foreign country in which such company is created or organized and which is calculated in the same manner as the Federal mid-term rate under section

1274(d). If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in such foreign country, such method shall apply if such company elects the method under this clause.

【“(C) CASH SURRENDER VALUE.—A method under which reserves are equal to the net surrender value (as defined in section 807(e)(1)(A)) of the contract.

【“(6) DEFINITIONS.—For purposes of this subsection—

【“(A) TERMS RELATING TO INSURANCE COMPANIES.—

【“(i) QUALIFYING INSURANCE COMPANY.—The term ‘qualifying insurance company’ means any entity which—

【“(I) is subject to regulation as an insurance company under the laws of its country of incorporation,

【“(II) realizes at least 50 percent of its net written premiums from the insurance or reinsurance of risks located within the country in which such entity is created or organized, and

【“(III) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

【“(ii) START-UP COMPANY.—A qualifying insurance company shall be treated as a start-up company if such company (and any predecessor) has not been engaged in the active conduct of an insurance business for more than 5 years as of the beginning of the taxable year of such company.

【“(B) LOCATED.—For purposes of paragraph (3)(A)—

【“(i) IN GENERAL.—A person shall be treated as located—

【“(I) except as provided in subclause (II), within the country in which it maintains an office or other fixed place of business through which it engages in a trade or business and by which the transaction is effected, or

【“(II) in the case of a natural person, within the country in which such person is physically located when such person enters into a transaction.

【“(ii) SPECIAL RULE FOR QUALIFIED BUSINESS UNITS.—Gross income derived by a corporation’s qualified business unit (within the meaning of section 989(a)) from transactions with persons which are not related persons (as defined in subsection (d)(3)) and which are located in the country in which the qualified business unit both maintains its principal office and conducts substantial business activity shall be treated as derived from transactions with persons which are not related persons (as defined in subsection (d)(3)) and which are located within the country under the laws of which the controlled foreign corporation is created or organized.

【“(7) ANTI-ABUSE RULES.—For purposes of applying this subsection, there shall be disregarded any item of income, gain, loss, or deduction with respect to any transaction or series of transactions one of the principal purposes of which is qualifying income or gain for the exclusion under this section, including any change in the method of computing reserves or any other transaction or series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of such exclusion through the application of this subsection.”

【“(8) COORDINATION WITH SECTION 953.—This subsection shall not apply to investment income allocable to contracts that insure related party risks or risks located in a foreign country other than the country in which the qualifying insurance company is created or organized.”

【“(9) APPLICATION.—This subsection shall apply to the first full taxable year of a foreign corporation beginning after December 31, 1997, and before January 1, 1999, and to taxable years of United States shareholders with or within which such taxable year of such foreign corporation ends.”

【(b) EXEMPTION FROM FOREIGN BASE COMPANY SERVICES INCOME.—Paragraph (2) of section 954(e) is amended by striking “or” at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting “, or”, and by adding at the end the following:

【“(C) in the case of taxable years described in subsection (h)(8), the active conduct by a controlled foreign corporation of a banking, financing, insurance, or similar business, but only if the corporation is predominantly engaged in the active conduct of such business (within the meaning of subsection (h)(3)) or is a qualifying insurance company.”

【(c) EFFECTIVE DATE.—The amendments made by this section shall apply to the first full taxable year of a foreign corporation beginning after December 31, 1997, and before January 1, 1999, and to taxable years of United States shareholders with or within which such taxable year of such foreign corporation ends.】